



Course Schedule

PART 1- IPO Knowledge - In the first week of the course, I will go over everything you need to know to completely understand the IPO markets. I will show you how to identify hot IPOs, how to receive stock in hot new issues, what lock-up periods are and how they affect stock prices, what after-market support means and much more.

PART 2- Hot IPO Pullback Strategy - In week two, I will teach you the rules and show you real examples of Jeff Cooper's Hot IPO Pullback strategy. In my opinion, this is one of the strongest strategies available for short-term traders to focus on when they are looking at IPOs.

PART 3- Identifying and Trading First-Stage Base Breakouts - Week three's lesson will be of special interest to intermediate-term traders. Many IPOs form long bases after their initial run-up. Some of the biggest share-price moves come after new issues break out of their first bases. I will show you how to identify these stocks, how to identify the base and the setups needed to enter these stocks as they make their moves.

PART 4- Shorting the Hype - Many hot IPOs eventually turn into tomorrow's big losers when they cannot live up to their expectations. I will show you the exact rules you can use to trade these stocks to the downside.

PART 5- Applying The Plan To Your Trading - After you have taken the course, you should have the ability to translate the knowledge into the real world. On May 12, we will be adding an IPO section to the site that you will have unlimited access to. This section will have database and screening capabilities to help you focus on the exact stocks to apply to your trading. In this last part of the course, I will show you exactly how to use these new features.

It doesn't take a professional trader or an investment banker to know there's something very special about getting in on an initial public offering of a nationally listed company. Many people who have never owned individual stocks have heard news reports about stocks that skyrocket on their first day of trading. This has created the popular image that IPOs offer one of the most potent ways to make a lot of money fast.

And for once, the popular image is correct! **Trading newly minted stocks can produce super-charged returns.** If you trade stocks, especially if you trade stocks using chart patterns, you definitely should learn how to fish in these waters.

However, the popular image of prodigious riches misses the **dangerous flipside** of IPOs.

In many ways, the IPO game is stacked against the individual trader in favor of the big, deep-pockets institutions that dominate Wall Street. And newly issued stocks pose special risks. They lack long trading histories which can help someone who uses charts make buy and sell decisions. And newly public companies usually are young, unproven companies, without long track records of earnings and sales growth and extensive coverage by outside analysts.

Yes, IPOs can heat up your profits. But they also can burn the ill-prepared.

Fortunately for you and me, professional traders have worked out time-tested tactics for trading these new issues. These techniques can give us a realistic shot at the tremendous profit potential of IPOs, while enabling us, with vigilance and discipline, to reduce risk.

I will take you, step by step, through **three of the best tactics** for trading new issues in the next three weeks of the course. Each involves chart analysis. All deal with trading newly issued stocks *after* they have come public. In other words, these tactics are for those of us who are not among the select few who manage to buy IPO stock at the offering price.

The first two tactics enables you to time entries into long positions -- the "Hot IPO Pullback" setup invented by TradingMarkets co-founder and short-term trader Jeff Cooper and the first-stage base, which some of you may have encountered in the work of William O'Neil, founder of Investor's Business Daily and author of *How to Make Money in Stocks*. The third tactic defines the precise conditions when you can short-sell new issues.

But before you and I leap into practical trading tactics, let's **get our bearings** this week.

Why do newly issued stocks behave so differently than more aged issues? Do newly issued stocks really outperform the market on average? If so, for how long? What factors might help some IPOs perform better than others? What do you, as a trader, need to know about how IPOs are structured by the underwriters and their pre-IPO owners? I will answer these and other questions this week.

And while few of us ever get to buy IPO stock at the delectable **offering price** before a stock goes public, there are ways to improve your odds at getting shares of these stocks. In this week's installment, I'll describe some things you can do to try to finesse IPO allocations.

Loren Fleckenstein

WEEK
ONE

IPO Knowledge

A Few Revealing Stats

Timing is key to trading stocks of any category. By timing, of course, I mean when you buy shares in a stock, and when you sell them. Or when you short-sell a stock and then buy it back. There are some unique performance traits of IPOs that you should keep in mind as you time your entries and exits.

A few revealing statistics and a little interpretation will tell you what I mean.

According to Thomson Financial Securities Data, the average one-day gain for stocks that came public from January 1996 through March 2000 on their first day of trading was 16.7%!

Small wonder that many investors who get IPO stock at the **offering price** sell their shares as soon as the stock debuts on the market. The offering price is what investors pay for allocated shares in an IPO by the underwriters. The underwriters try to price the stock below where they think it will trade, putting the odds very much in favor of a nice, fat one-day pop right at the opening of trading.

Okay, you say, well that's fine -- for those select or lucky investors who manage to get in on the offering price. Powerful institutional investors gobble up the vast majority of this choice feast. But what about most of us mortals?

Well, plenty of fruit is still in the melon for you, even after a stock goes public and starts trading! The key, though, as I said, it *timing*!

Short-Term Leaders

Robert Natale, a managing director at Bear Stearns Asset Management, is a well-known authority on IPOs. Once you finish my five-week course, if you want to deepen your knowledge of IPOs, I heartily recommend Natale's book, *Fast Stocks, Fast Money: How to Make Money Investing in New Issues and Small Company Stocks* (McGraw-Hill 2000). Natale's book does *not* deal with trading chart patterns, but it offers an extensive base of knowledge about why IPOs and small-cap issues tend to outperform the market and how investors, as opposed to traders, can take advantage of these opportunities.

Natale points out new issues tend to lead the S&P 500 by a wide margin over their first three months of trading, even after one accounts for the pop from offering price to first-day market close.

Of 370 new issues appraised by Standard & Poor's during the years 1992 through 1994, 241 outperformed the S&P 500 from the first day of trading over the following three months. The average three-month return for these hot IPOs was 19.6% vs. average gains of 1.7% for the S&P and 2.6% for the Nasdaq Composite over the same time frame.

Long-Term Laggards

But as Natale warns investors, "don't hang on too long." While IPOs tend to outperform the market in the first few months of trading, they underperform further out.

To illustrate, Standard & Poor's analyzed the performance of the IPO class of 1990 during the first 15 months of trading. On average, they climbed 50.5%, leading the S&P 500 but lagging the Nasdaq Comp.

More significantly, only 46% of the new issues did better than the IPO. So a handful of the best IPOs obscured the fact that most new issues fared poorly compared to the market.

Two powerful factors lie behind this short-term outperformance/long-term underperformance of IPOs.

The team of investment banks and brokerages that takes a company public sets loose an army of sales people to hawk the offering to their clients, creating the buzz and stirring up a surge of demand of the new issue. The momentum from this marketing drive continues for some time in the aftermarket.

While demand is artificially stimulated, supply is artificially restricted. Often, most shares in a newly public company lie in the hands of insiders. But this supply of stock is prevented from coming to market for a period of time, usually six months, by a **lock-up agreement** between the underwriter and the insiders.

Of course, the sales effort comes to an end after the IPO, and the buzz fades. The lock-up agreement expires, opening up more supply into the market. The supply-demand relationship shifts against the stock as selling pressure increases, buying pressure decreases.

Your Window of Opportunity

What does this mean for traders like you and me who likely will buy most of our IPOs after others have dined at the offering price? Broadly speaking, it means that we can still get in on market-beating gains by trading IPOs, but we have to get in on these issues early enough to benefit from their added fuel.

Now, Natale's work is aimed at investors, not chart traders. So I am *not* recommending that you should consider any new issue over three months in age to be automatically over the hill. The point here is to appreciate the importance that youth plays in the vigor of these issues.

"In terms of a universe of stocks to go long, IPOs after the first three-to-six months are not very fertile ground," Natale told TradingMarkets.com. "But there are always the exceptions you can search for, and there are many of them."

Ultimately, as we get into specific chart patterns, the pattern will dictate your course of action, be it buy, sell or sell-short. Jeff Cooper's *Hot IPO Pullback*, for example, comes into play on the very first two- to four-day pullback after a new issue's first advance. That's pretty early.

On the other hand, let's say a new issue breaks out of a *first-stage base* six months after coming public. That scenario could very well offer a good entry for the intermediate-term trader. Then again, if a first-stage base occurs within, say, three months of IPO, that stock could have an added advantage working for it.

Hot IPOs and the Market

More than most other categories of stock, new issues tend to live and die by the health of the general market. They deliver their most outstanding returns when the stock market is in an uptrend or bull phase. They tend to lag when the market is flat or in a downtrend or bear phase.

Bet on IPOs in an advancing market, you improve your odds of generating large profits. Bet on IPOs in an adverse market, you increase the likelihood that you will suffer losses and fare worse than the market.

As I put the finishing touches on this course, the Nasdaq is in a bear market. The Nasdaq Composite Index has declined 35.3% from March 10 intraday high to April 14 close. Over the same time frame, the Investor's Business Daily New Issues Index has tanked 50.6%!

So it's important that the trader of IPOs have a system for determining the state of the market. Ask yourself these questions: How do you determine whether a rally in the major indexes after a long decline is truly the start of a tradable uptrend, or just a bounce on the way to lower lows? Under what conditions would you sense that a recent advance is showing signs of aging and breaking down? Can you identify a set of *leading stocks*, stocks that seem to pace the market to upside and to the downside?

If you have trouble answering those questions, TradingMarkets.com offers extensive course materials to aid you in determining the condition of the market. In particular, check out Week Four of the [Kuhn/Marder Intermediate-Term Momentum Trading Course](#).

While the market weighs heavily on IPOs, IPOs also can give you valuable clues about the condition of the market. In particular, frenzies over new issues can signal the kind of excessive optimism, or greed, that characterizes market tops.

We just saw a great example of this. The investment banks that underwrite IPOs deliberately underprice these issues. This helps ensure good demand to sell into when trading begins. The average one-day gain for IPO stocks on just their first day of trading was 16.7% during the period from January 1996 through March 2000.

But look what happened in the months leading to the Nasdaq top in March 2000. These numbers come courtesy of Thomson Financial Securities Data. Stocks going to market in August 1999 delivered an average one-day gain of 14.9% for the month. Then the returns started climbing -- September 21.1%; October 26.4%; November 29.4%; December 39.9%; January 2000 31.1%; February 39.8%; March 2000 30.5%.

These were extraordinary returns, even by IPO standards. And they signaled the kind of final, incandescent burnout that occurs near a market top.

You don't need a statistical scorecard to keep track of the IPO climate. Just by paying attention to the IPO market on a daily basis, you can get a sense of the speculative pitch. Soon TradingMarkets.com will launch an expanded IPO sections. But our site already assembles extensive IPO news and information. Click on the *Stocks* tab near the top of any TradingMarkets page, then click on *Quotes & Research*, then scroll down to the *IPO Information* link.

Jeff Cooper recalled a revealing IPO bellwether:

"The day Palm came public was within 10 days before the Nasdaq top. The stock opened up and closed poorly and continued to droop down. In my mind, that was kind of an omen for the Nasdaq because Palm was one of the most anticipated IPOs. Then I saw the chairman or the CEO for the company interviewed the day of the offering on TV. The guy was wearing a pinstripe suit, and the guy told the interviewer that the pinstripes were in solid 24 karat gold! That was a close as you come to a bell ringing. And this was a tall guy too. There was a lot of gold in that suit! Just little things like that make the hair on the back of your neck go up."

IPO Cycles

An upward surge in one-day gains holds other implications for the trader. If the one-day gains get too fat, they can sap a stock's ability to advance and outperform further out. In a future installment, we'll discuss the ins and outs of Jeff Cooper's *Hot IPO Pullback* setup. But the basic idea behind the tactic is to hop aboard an strongly advancing new issue after it undergoes its first pullback.

The problem in early 2000 was that some IPOs were exploding so fast out of the gate, that they had nothing left down the track. Cooper notes:

"Some of these stocks that opened 50 to 100 points from the offering, they burned themselves out from the get go, like a roman candle. So there were no Hot IPO Pullbacks."

IPO expert Robert Natale has observed a parallel development in the offering price, before a stock even hits the market. When an industry heats up, the first IPOs price at lower valuations relative to trailing earnings or cash flow or other fundamental metrics of corporate performance. But with each successful offering of a representative of that industry, the offering price goes higher.

Naturally, these high share-price multiples attract more companies and underwriters eager to cash in with their own IPOs. Stocks are offered at ever higher multiples, and if market demand runs strong enough, these IPOs trade up even higher on their first day of trade. The result leaves less and less fruit in the melon, so to speak, for those of us who seek to enter the new issues using chart patterns.

The IPO Process

Now let's discuss how these IPOs are put together and sold by the company coming public and its underwriters.

Once a privately held company makes the decision to go public, it hires a *lead investment bank* to serve as underwriter as well as an accountant and law firm. The first major step is the creation of the **prospectus**, a detailed document describing the business, the use of proceeds to be raised in the IPO, corporate financial statements, ownership, statement of risks, lock-up agreements imposed on insiders and other key information concerning the company and the offering.

The preliminary prospectus then is filed with the Securities and Exchange Commission as part of the company's *S-1 registration*. You can obtain copies for free from the lead underwriter or the company. You also can download the S-1 from the [SEC's database, EDGAR, on the Web site](#).

As I said, this is a *preliminary* document. It remains for the SEC and other regulators to pick the document apart and require any revisions and additions to be made in subsequent amended filings. In fact, the SEC requires that the front page of the initial prospectus be printed in red ink, putting the public on notice that the document remains subject to review and probable revision. For this reason, the preliminary prospectus is often referred to as a **red herring**.

This course is ultimately aimed at *traders* who trade new issues using chart patterns. For *investors* who want to learn how to evaluate a prospectus, I recommend Natale's book, *Fast Stocks, Fast Money*, and in particular, Chapter 6, "Decoding the Prospectus."

The lead investment bank pulls together a **syndicate** of other investment banks to help underwrite the deal and sell allotments to their clients. The investment banks get to work, sounding out their clients to gauge demand for the deal at the stock's offering price. For this service, the syndicate members pocket underwriting fees and commissions, taking more money out of the eventual proceeds raised in the IPO.

This difference is stated as a percentage and called the **gross spread**. Let's illustrate with a simplistic example. Say a company comes public, selling 4 million shares at an offering price of 16 per share, raising \$64 million. The underwriting team pockets \$4.48 million in fees, leaving \$59.52 million for the company. So the gross spread would come to 7%.

Next comes the **road show**. Over one to two weeks, the top executives of the company going public and the investment bankers hit a number of major cities to meet directly with analysts and money managers in an effort to persuade institutions to buy large allocations at the offering price. Above all, this courtship has centers on the mutual funds, which have wielded overwhelming buying power since at least the late 1980s.

This brings us to a big point of controversy. **Road shows are closed to the public**. Only the representatives of deep-pockets institutions are invited. The retail investor and individual trader are not.

David Menlow, president of IPOfinancial.com and a leading authority on new issues, feels the day is coming when the SEC will compel the opening of road show meetings to the public. The agency has proposed broadcasting these sessions via the Internet.

"It's something that should happen and something that will happen," Menlow said. "Investors who are shut out of these road shows are going to be putting too much pressure on the SEC because this smells of an insider trading scenario. Why are individuals shut out? Is the road show about telling institutional investors something different than the retail investor? And if so, then what about full disclosure? Shouldn't everything that is discussed about the company prior to the offering be in the prospectus? And if it's in the prospectus, why can't the retail investor hear it?"

After the road show and the acceptance by the SEC of the final prospectus, the company and underwriters enter the challenging phase of setting the final offering price and the number of shares of the offering.

Obviously, management and inside investors want the highest possible price for the offering, presumably to raise maximum possible proceeds for the good of the firm as well as their own personal gain. The underwriter also benefits from a higher rather than lower offering price. Its **underwriting fee** is set as a percentage of the total capital raised -- typically between 5% and 9%.

But setting the price too high can trigger a backlash. As Natale notes in *Fast Stocks, Fast Money*, underwriters also act as market makers in the stocks they bring to market. Overpricing a deal can cost them trading profits in the aftermarket.

More importantly, in the days following the IPO, the underwriting syndicate is committed to support the stock at the offering price. If the share price falls below that level, this puts the underwriter in the position of having to buy back shares, putting the investment bank's own capital at risk.

Falling below the offering price is **deadly** for a newly issued stock! In fact, as we'll see later in Week No. 4 of this course, such an event can offer a profitable opportunity to sell the stock short.

So the key is to slightly underprice the deal, leaving as little money on the table as possible while still setting the offering low enough to ensure healthy trading in the aftermarket.

The investment bank also has a handy option in case the stock does trade up substantially in the aftermarket -- the over allotment option. This option -- called the **green shoe**, in Wall Street parlance -- authorizes the underwriter to buy more shares from insiders or the company at the offering price. Of course, the underwriter then can turn around and sell those shares in the aftermarket.

So as you can see, from the underwriting fees and commissions levied by investment banks and brokerages, to the offering price enjoyed by clients who get in on IPO allocations, a lot of cream is skimmed off the top before a new issue starts trading in the secondary market!

Finally, the offering price is set and typically announced a day or two before the stock starts trading.

Most institutions that take allocations will **flip** their allocations, in other words, selling immediately into the secondary market soon after the opening of trading and pocketing a fast profit.

But as we'll see shortly, underwriters go to great pains to prevent others from taking quick profits like the institutions. If you, as an individual investor, manage to get your hands on IPO shares at the offering, chances are your broker will set up disincentives to deter you from flipping your shares. Meanwhile, company insiders also have their hands tied by **lock-up agreements**, which require them to hold on to their stock for some period of time after the IPO, typically six months.

These restrictions have the goal of stabilizing the stock's price after the open and preventing it from falling below the offer. That's a justifiable goal. After all, how else could companies and underwriters persuade investors to buy stock in a company that, in most cases, is relatively young and has no established trading history for its shares?

But again, the little guy who manages to get in on an IPO at the offering price seems to be doing most of the noble work here. Nobody is asking the *institutions* to forego flipping *their shares* for the good of share-price stabilization!

Meanwhile, the underwriting team continues to play a brief role to ensure an orderly, stable market in the stock immediately after shares begin trading. As I noted earlier, the underwriter can step in and buy shares to support the price.

But syndicate support is not something to count on. Some new issues do breach their offering prices. And underwriting teams don't stay together indefinitely once a new issue begins trading.

"It varies," Menlow noted. "It could be a day, or it could be a month. It could be for whatever period of time they choose to make. Morgan Stanley would say one thing, Lehman would say another, Salomon something else. And it varies with the deal. If the deal is running away from itself, there is less of a need for a syndicate group to remain together. If a deal is struggling, it would take longer."

Underwriters can even *short* the stock. Sometimes, they do this to prevent a new issue from running away from itself in early trading. An underwriter can short a fast-running new issue, then cover the short by exercising the green shoe.

But there are other more questionable shorting practices as well. In some of the less substantial new issues, brokers sometimes will solicit you, offering IPO stock at the offering price on condition that you buy the same amount of the issue in the aftermarket. This helps ensure the new issue will trade higher out of the gate.

Eventually, the aftermarket sales effort ceases, and with it, this artificial prop beneath the stock price. As Natale reveals in *Fast Stocks, Fast Money*, it's not unheard of the "underwriting firm, some of its affiliates, or its partners' cronies to short the stock, knowing that once their selling effort ends the stock will drop."

Getting IPO Stock at the Offer

This course is about trading new issues *after* they come public, not about trying to get in on IPO allocations at the offering price. Nevertheless, I promised to discuss some ideas about how you can improve your odds of getting in on stock at this (usually) below-market price. And I'll also describe the drawbacks that can come your way if you do manage to snare shares at the offering price.

Flipping is the practice of buying IPOs at the offering price, then selling those shares as soon as the stock starts trading. Underwriters try to underprice the offering, mainly to ensure sufficient demand for the stock in the aftermarket.

This makes flipping a lucrative practice for those lucky enough to get in on IPO allocations. For stocks that came public from January 1996 to March 2000, the *average* from offering price to closing price on the first day of trade was 16.7%!

And of course, we've all heard of examples of stocks that shot many times higher than offering. FreeMarkets sold 3.6 million shares at an offering price of 48 a share. The stock opened at 248 when trading commenced on Dec. 10. Linux software maker Red Hat priced initially at 14, then surged at the open Aug. 11, 1999 to close at 52.06.

Ah, if only you could regularly get your hands on IPO stock at the offering. That would be fast, easy money!

Here are the unfortunate facts of life for the individual trader and investor.

First, institutions -- the mutual funds in particular -- snap up the lion's share of offering-priced stock. After they have feasted, there's precious little supply left for you and me.

Now, that said, you can improve your odds of getting your hands on IPO allocations.

Check to see if your broker offers an IPO allocation program. Online brokers such as E*Trade and Wit Capital, of example, have programs that make offering-priced stock available to their account holders. If so, you can increase your odds further in some cases by establishing more than one account with the brokerage.

Another route is establishing an account with a full-service brokerage house that participates in a lot of IPOs. Then check with the local branches and explain that you want to establish a long-term relationship with the office broker who has produced the best results in terms of getting IPO allocations for his or her clients. Robert Natale, a nationally recognized expert on IPOs, goes into this approach in detail in his book, *Fast Stocks, Fast Money*.

Even if you manage, though, to secure a source of IPO stock at the offering, the potential rewards may be less than meet the eye.

Institutions demand the freedom to flip their offering-priced shares, and underwriters let them do it because they need access the institution's enormous buying power. But the underwriters slap the handcuffs on the individual when it comes to flipping.

Brokerages typically grant IPO allocations to you or me on the condition we hold our stock for a month to two months after the stock starts trading. Sell sooner, and your brokerage may cut you off from future allocations.

A postponement of even a few days or weeks is long after the Wall Street big shots have blown out their positions. By then, you may have missed your opportunity to cash in the big pop.

Furthermore, IPOs typically are done by new, relatively untried companies. And IPO stocks tend to suffer even more than the general market during corrections and bears. A disciplined trader wants *nothing* to come between him and the decision to sell a stock to cut losses as well as take a profit.

Depending on a relationship with a full-service broker for access to IPO allocations also can have its drawbacks. First, nothing comes for free. Why would a broker want to give you access to a special opportunity? For one reason: Your account generates sufficient commissions or fees to make it worth the broker's while.

Broker relationships can bring other headaches as well. Short-term trader Jeff Cooper used to get offering-priced stock from brokers with whom he had cultivated good relationships. He eventually decided keeping his brokers happy to keep the IPO stock wasn't worth the hassle.

"For a broker, there's only one good client -- one who generates lots of commissions," Cooper said. "And that wasn't enough (to get special treatment for IPOs). They wanted us to buy their firm's recommendations. After doing that for a while, I realized that as soon as a stock opened, it would pop up, then get hit. In my estimation, the brokers were using retail client if they had an institutional client that wanted to be a seller. It didn't allow me to be my own person."

Meanwhile, Cooper had cause to doubt the quality of some IPO deals being proposed to him.

"If a deal was very hot, the broker might say they would give me 5,000 shares," Cooper recalled. "Then just before the deal, they always called to say they were cutting back. Whereas if the deal was a dog, then they'd call back say, listen can you do me a favor? I'm going to give you 10,500."

Watching the Insiders

When people think of the prospectus, they often focus on the reams of corporate fundamentals contained in the document. But traders who rely on technical analysis can find useful information regarding the two most important factors in technical analysis: **price** and **volume**.

If I can digress for a minute, technical analysis boils down to one thing, regardless of the trader's choice in technical paraphernalia. You can use moving averages, trendlines, chart patterns, net cash flow metrics, pullbacks, breakouts, whatever. The goal is to identify and exploit imbalances between supply of a stock and demand for it.

Bulls, or buyers, look for junctures where demand for a stock appears likely to outstrip supply and propel the share price higher. Bears, or short-sellers, seek the opposite situations. They look for signs that the supply of a stock seems on the cusp of overwhelming demand, promising to submerge its share price.

This brings us to the supply of stock in the hands of insiders in newly public companies. Often the amount of these shares exceeds the supply sold at the offering.

Underwriters lock up this supply of stock for a period of time to prevent insiders from cashing out at the open en masse and overwhelming aftermarket demand. The **lock-up agreement**, contained in the prospectus, restricts insiders from immediately selling their large holdings after trading begins. The lock-up period typically lasts six months.

Some traders short stocks near the expiration of the lock-up period, although never short a stock simply on that basis alone! A powerful professional buyer with a keen interest in the stock could just as easily take advantage of any additional supply coming to market as an opportunity to acquire a large position. But obviously, you should take the expiration date into consideration when deciding whether to take a position in a new issue.

Also, don't assume that the mere existence of a lock-up agreement ties up all of the insider shares for the stated time frame. Insiders often are free to sell a portion of their shares within the lock-up period.

So as you develop your target list of new issues to be tracked for technical setups, be sure to check each issue's prospectus for the number of shares controlled by the lock-up agreement. For potential buys (i.e., long positions), I like Natale's rule of thumb: The amount of insider shares *not* covered by the lock-up should not exceed 50% of the shares sold through the IPO.

Another insider red flag lies in the **dilution section** of the prospectus. In this part of the document, you will find the relative contributions of existing and new investors. What is the average price paid per share by existing shareholders? In a healthy company, these investors typically pay in less for their shares than those who buy at the offering price. It's a troubling sign if the average insider cost comes in just short of, or above, the offering price. As Natale notes: "The investment still could be a good one, but more often than not, the problems that prevented the company from increasing in value as a *private concern* will restrain its progress as a *public one*."

I hope you've found this installment useful. Next week, we'll dive right into hands-on trading tactics using chart patterns, starting with Jeff Cooper's Hot IPO Pullback strategy.

WEEK TWO Hot IPO Pullback Strategy

A big welcome to Week 2 of my five-week course, **Trading Hot IPOs!**

In this installment, I'll teach you the first of three tactics for trading stocks soon after their initial public offerings.

The technique *du jour* is the **Hot IPO Pullback** invented by short-term trader and TradingMarkets.com cofounder Jeff Cooper. The Hot IPO Pullback is a momentum-continuation pattern used to time entries for short-term trades.

In a nutshell, here's how it works. A new issue will trade more than 15% above its offering price. The pattern occurs when the stock undergoes its first two-to-four-day pullback. The buy signal occurs if the stock rises 1/16 point above the prior day's intraday high.

As I think you'll soon discover, you don't need to get in a new issue at the offering price in order to profit handsomely from IPOs!

I love the Hot IPO Pullback pattern for two reasons.

The first is effectiveness. No chart pattern works flawlessly every time. But the Hot IPO Pullback is one of the most productive patterns that I've come across. It works very well as an entry for short-term trades lasting several days, at the longest, from buy to sell.

Secondly, you can learn to recognize valid Hot IPO Pullback patterns right off the bat. This sets the pattern apart from many other chart formations which come with all sorts of nuances and exceptions. Developing sound pattern recognition generally takes years of scrutinizing charts. But the Hot IPO Pullback can be learned relatively quickly.

So without further ado, let's jump right into trading the Hot IPO Pullback!

Momentum Continuation

As Jeff Cooper puts it in his book, **Hit and Run Trading II**: "A stock remains in motion, until proven otherwise." That's the essence of momentum trading. You stay with the trend until it reverses.

However, simply buying a stock because it's rising is a recipe for failure. You would run the risk of getting caught in a pullback as existing shareholders sold to take profits off the advance that caught your attention in the first place.

At some point, such a pullback could force you to sell in order to prevent your deteriorating position from snowballing into a big loss. After all, how do you know where your deteriorating stock is headed? The decline could be an uneventful pullback, only to be followed soon by an advance to higher highs. Or the stock could be starting a bloody slide to oblivion.

What if you could sidestep the pullback, then climb aboard, once the stock reverses and forges ahead for a fresh climb? That's the idea behind **momentum continuation** patterns.

Jeff Cooper observed that stocks in explosive moves often pulled back for only two or three days before striking out on a fresh advance. This insight forms the basis of Jeff's **1-2-3-4 setup**, a well-known momentum continuation pattern.

The 1-2-3-4 approach works like this. You wait for a fast-rising stock to pull back for three days, then buy if it resumes its uptrend. Jeff describes the pattern in detail in **Hit and Run Trading I**.

The **Hot IPO Pullback** works much the same way. You keep your eye on new issues that advance strongly soon after their IPOs. You wait patiently for these strong runners to have their first pullback. This permits the "flippers" -- shareholders who got in at the IPO offering price -- to sell their stock and take profits.

At this juncture, other traders and investors who were waiting for the flippers to get out of the way, jump in and start buying. If their demand is strong enough, it pushes up the share price.

Now it's your turn. You snap up shares as soon as the stock's price rises sufficiently to confirm a likely resumption of the advance. If all goes well, you pocket a quick trading profit a few minutes, hours, or days later.

If the stock reverses again and turns against you, you sell once the price triggers your **protective stop**, a price below which you will not stay in the stock, keeping your loss minimal.

That's the idea. Now, let's check out the nuts and bolts of the Hot IPO Pullback pattern.

Hot IPO Pullback Rules

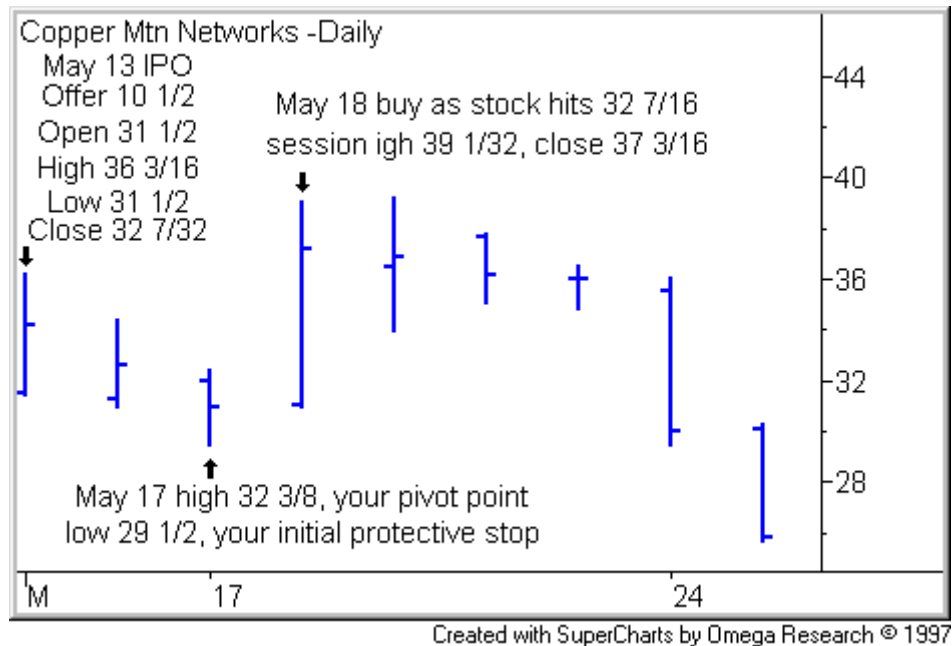
There are only five rules for trading Hot IPO Pullbacks, and they're simple.

1. Find a company that has traded more than 15% above its offering price. For instance, if an initial public offering was priced at \$10 a share, the stock must trade higher than 11 1/2 a share.
2. Wait for a two- to four-day pullback. This can take the form of any mix of lower session lows, lower closes, inside days, etc.
3. After the pullback, buy if the stock rises 1/16 point above the prior day's intraday high.
4. Set your initial stop at the prior session's intraday low.
5. Hold the position for one to five days. Be aware that the longer you hold, more the likely something can go wrong.

A Hot IPO Pullback

Okay, now let's look at a few daily stock charts to illustrate how this works in practice. All charts in this course use **split-adjusted prices, including offering prices**, in the event the featured company has split its stock.

Copper Mountain Networks develops DSL technology that enables carriers to provide high-speed data and voice services over copper wire. The company came public May 13, 1999. Copper Mountain sold 4 million shares of common stock at an offering price of \$21. Morgan Stanley Dean Witter acted as lead underwriter. The stock's split-adjusted price was 10 1/2 at the time I created this chart.



Copper Mountain opened at 31 1/2 and shot straight up, touching a session high of 36 3/16 and finishing the day at 32 7/32. Then the stock went into a two-day pullback, staying well above its offering price.

As I said earlier, the pullback can take the form of any mix of lower lows or lower closes or inside days. Copper Mountain made lower intraday and closing lows on both days of its pullback.

The setup's **buy signal** keys off the intraday high of the last down day in the pullback. Copper Mountain shares made an intraday high of 32 3/8 on its last pullback day. Then in the next trading session, the stock reversed to the upside. In a Hot IPO Pullback, you buy once the stock exceeds the prior session high by 1/16 point.

In Copper Mountain's case, the time to enter came as soon as the stock hit 32 5/16 on the bid on May 18. Shares rose past that level and kept on running, making a new all-time high of 39 1/32 before closing the May 18 session at 37 3/16.

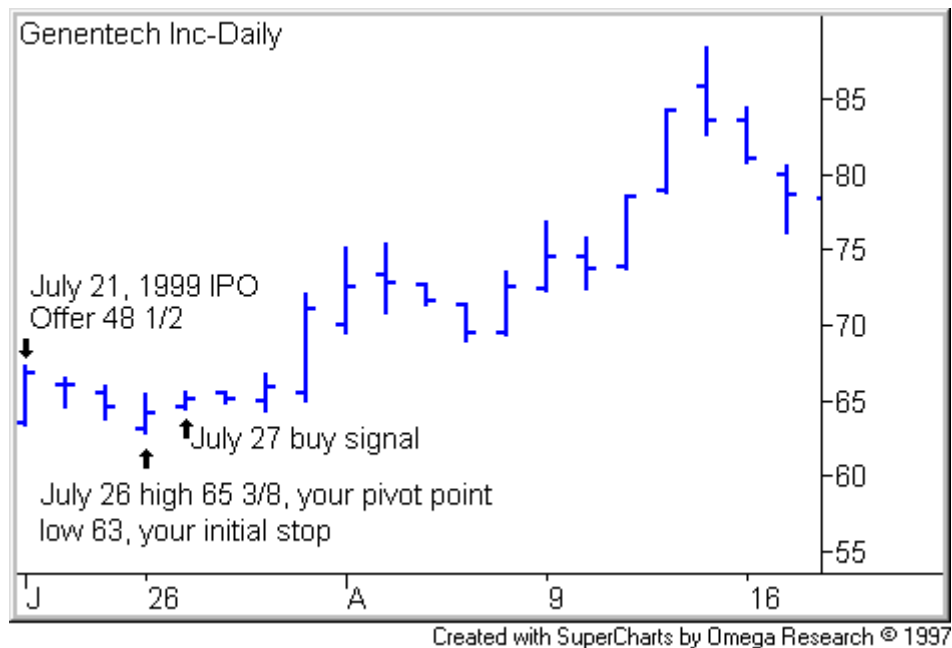
The chart also shows where you would have set your **initial protective stop** -- at 29 1/2, the low of the session before you bought your position. This is where you would have sold in the event the new buy had reversed and dropped against you. More on stops and selling later in this installment.

When you get a valid buy signal or a sell signal, don't hesitate! Short-term and intraday traders -- for whom this setup works best -- make the bulk of their money doing lots of quick trades for small percentage profits. You must execute instantly or risk the stock moving away for you, costing potential profits or inflicting greater losses.

Let's assume you managed to buy your Copper Mountain shares at, say, 33. Assuming you held until the close, you would have been ahead more than 12% by the end of the session. Not bad for a day's work!

Another Hot IPO Pullback

Sometimes a stock bought off Hot IPO Pullbacks doesn't shoot straight up. This is not a cause for concern provided the stock holds above your initial stop. The trade still can work out. A good example is the biotechnology company Genentech.



As you can see, Genetech opened well above the offering price. The stock pulled back over the three days after the IPO. On July 27, 1999, the stock slightly exceeded the prior session high, flashing a buy signal. Then stock traded sideways for a couple more sessions before breaking out for a nice run.

Later in this installment of our course, I'll discuss tactics to help you decide when to **sell to bank a profit**. For now, I'll just repeat that Jeff Cooper intended this pattern for the short-term trader, who might hold a position *one to five days*, and the day trader, who usually turns over the same position within the same trading day.

Let's discuss the general idea of **initial stops** and **cutting losses**. Then I'll introduce Jeff's recommended **initial stop** for the Hot IPO Pullback and **selling to take a profit**.

Cutting Losses

Over a successful career, you're going to be wrong on many trades. Small losses are part of the cost of doing business for all successful traders. The key is to prevent small losses from becoming big losses.

A full treatment of money-management techniques is beyond the scope of this course. But I wanted to emphasize two **critical principles** before moving on to the specific selling techniques for Hot IPO Pullbacks.

- 1. Never buy any stock without setting an initial stop, a price level where you will sell to keep your loss small in case the stock price falls against you.**
- 2. Never procrastinate or make excuses to justify holding onto a stock once it contacts your initial stop. Such amateurish behavior may keep you in an occasional winner. But eventually, this will set you up for a catastrophic loss. Stick to your discipline. When a stock hits your stop, sell!**

The idea here is to protect your precious capital in order to fight another day. Admit your mistakes, and let your winners make up for them.

Imagine that you're a short-term trader. You typically hold a position, say, for two to four days. Looking back over a year of trading, you see that you executed 150 complete trades (from buy to sell). To keep our illustration simple, we'll assume equal dollar-sized positions.

In this pretend example, you made money on 65 of your trades and lost money on 85. In other words, you picked winners in 43% of the time and losers 57% of the time.

But even though you lost money on the majority of your trades, your account cleared a profit! How is this possible? By cutting your losses short and letting your winners run. In this imaginary case, the average gain of your winning trades came to 6% while your average loser was 2%.

Now let's do some simple arithmetic. Divide your percentage of winners by your percentage of losers. In this case, 43/57 rounds out to 0.754.

Next, divide your average gain by your average loss. So $6/2 = 3$.

Now multiply the two quotients. Thus 0.754×3 rounds out to a **performance ratio** of 2.3. Over a year of trading, you made money 2.3 times faster than you lost money!

As a rule of thumb, I think any initial stop that would allow a loss greater than 2% of your total trading account equity is excessive. Many traders refuse to risk more than 1% of their total capital in an initial stop on a single trade. Short-term traders often will not let a stock move more than a point against their positions.

More Reading to Protect Your Account

If these money-management considerations are new to you, you owe yourself further study. You're courting disaster if you trade without a well-thought-out plan for controlling losses, adapted to your financial wherewithal and your trading strategy.

For starters, I recommend that you read my lessons on my tutorials on [trading time frames](#) and [risk management](#).

From there, check the Money Management part of the Stocks Education section of TradingMarkets.com.

Taking Profits

Selling to contain an outright loss is simple. If a new buy falls to the point where it hits your initial stop, you sell. Period. No excuses. No waiting. No debate. No regrets. You sell and look for your next trading opportunity.

But what about your winners? Once a stock advances well beyond your cost, at what point should you **sell to take a profit**? Many successful traders find this kind of selling to be one of the hardest aspects of trading.

At what point should a stock be cashed out vs. allowed to run in hopes of building greater profits? If you find this issue a tough one, give yourself a break. You're not alone. The answer is not always obvious, even to seasoned traders.

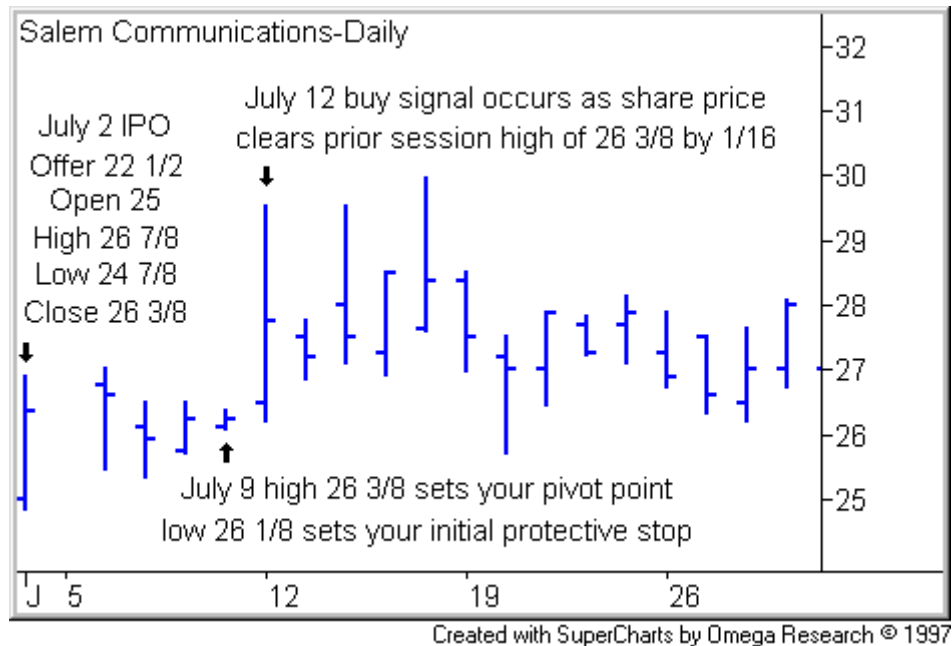
I believe Jeff Cooper's system works best if used as he intended it -- for short-term trading with profit-taking within days -- if not hours or minutes -- of the buy.

"You can use this strategy with a trailing stop, trading it within the confines of your own trading style," Cooper said. "I'm a short-term trader because I believe that anything can happen the longer you're in a stock. More things can go wrong. I believe in two- to three-day movements in the market."

There are several ways to deal with the problem of when to sell at a profit. If you can monitor your position continuously through the day, switch to a **trailing stop** once the stock shows a profit worth protecting. Continue to move up your stop in price as the stock rises. Sell if the stock reverses and tags your stop.

Making the Quick Kill

Let's take a look at a *daily* chart of Salem Communication Corp., a radio broadcasting company providing religious and family-oriented programming. This example shows how fast the profits can come, and how fast the market can take those profits away!



Salem came public at an offering price of \$22.50 on July 2, 1999. The stock looked promising right out of the gate. Shares opened at 25 and headed higher, closing at 26 3/8 in the upper half of the day's trading range. (As we'll discuss later, closing below the open or in the lower half of the first day's range, even when the stock is still above its offering price, can be a sign of trouble.)

As Salem pulled back, the stock became *less* volatile just before the buy-signal day. This is a healthy sign that shareholders were sitting tight, a condition that will force would-be buyers to bid up the stock in the event strong demand comes to market.

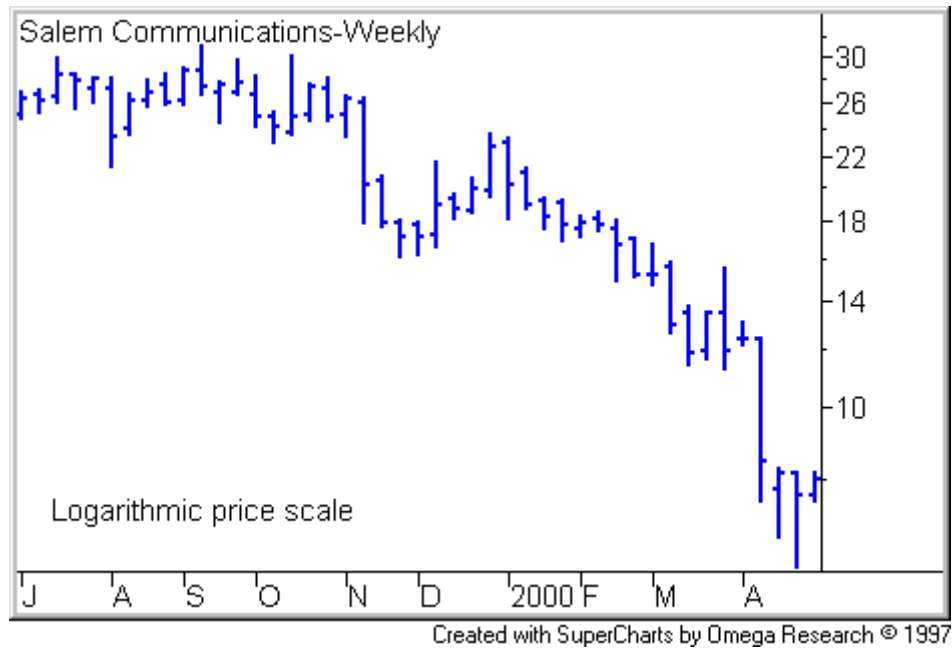
Then on Monday July 12, the stock surged, generating a buy signal after clearing the Friday July 9 high of 26 3/8 by 1/16 point. The share price ran as high as 29 1/2 before settling for a close of 27 3/4.

As I've said earlier, Cooper intended this strategy for short-term trading. A professional trader -- someone who can spend the entire day watching the screen -- could start with the prior-session low as the initial stop, then switch to a 1-point trailing stop once a stock has advanced far enough to yield a paper profit worth defending.

You also could stick with an initial stop set at the prior session low of 26 1/8, then carry the position, not selling until it either hit the stop or advanced to some pre-desired percentage return. If by Day 4 or 5 of the trade, the stock had done neither, the short-term trader probably should sell. For some reason, the advance has not resumed. That can signal something's amiss.

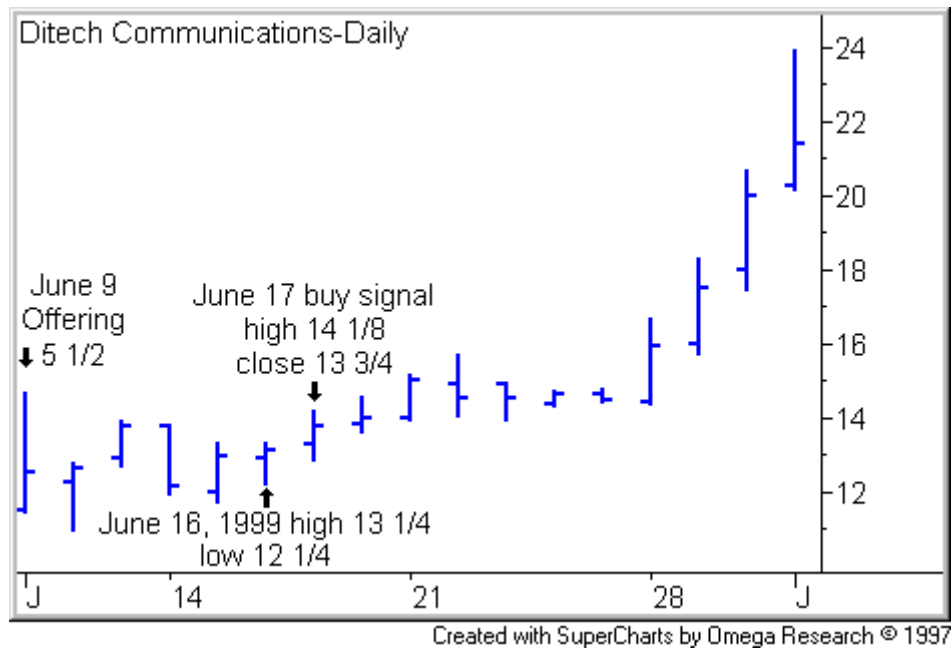
As the above chart shows, even if you missed selling near the intraday high, Salem still would have returned around a 4% profit for anyone selling near the close. Salem also gave short-term holders two other chances to sell for greater gains. The stock tagged intraday highs of 29 1/2 on July 14 and 29 15/16 on July 16.

Not all horses that come charging out of the gate amount to much down the stretch. And Salem shares certainly illustrate that fact, as you can see in the following *weekly* chart, which tracks the new issue from IPO through March 31, 2000.



Ditech Example

Ditech Communications came public on June 9, 1999. The IPO sold three million shares of common stock at a split-adjusted price of \$5.50 a share. The underwriting syndicate was composed of Deutsche Banc Alex. Brown, BancBoston Robertson Stephens and Hambrecht & Quist.



Out of the chute, Ditech traded above, but not far above, its offering price. On June 15, the fifth day of trading, it managed to close at 6 9/16 after tagging an intraday high of 6 5/8. The close of 6 9/16 put the stock 19% above its offering price. So the stock qualified as a Hot IPO Pullback.

On June 19, Ditech opened at 6 5/8, the prior session high, and then advanced, taking out the prior session high and generating a buy signal. Again, you set your stop at the intraday low of the prior session, which in this case would have been 6 1/8.

Ditech took off from the June 19 buy and never looked back.

Market Conditions

When you trade long, in other words, buy a stock in hopes that its price will appreciate, you want as many factors as possible pulling in your favor. That means buying momentum stocks in the midst of a market uptrend and sitting out long trades in a declining market. This goes double for new issues.

As I discussed in the first week's installment of this course, **new issues tend to outperform the broader market during rallies and bulls. New stocks fare worse in corrections and bears.**

For short-term purposes, Jeff Cooper suggests a positive market meet this condition: The general indexes should be above their rising 10- and 15-day moving averages.

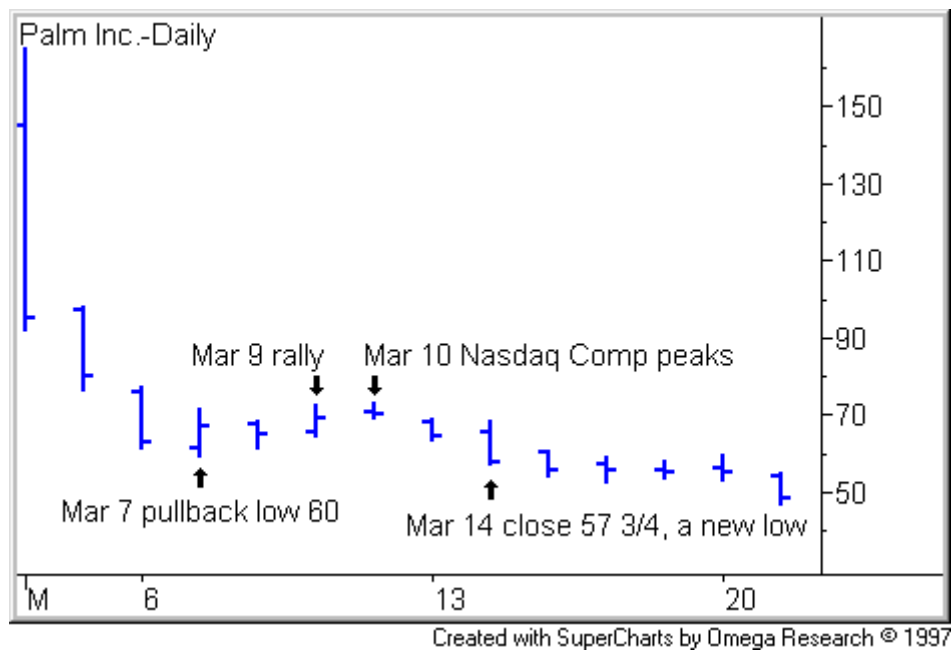
Warning Signs

The Hot IPO Pullback is one of the simplest, most effective setups that I know of. But there remain warning signs that apply even when a new issue manages to advance 15% or more from the offer in its first five days and offer a Hot IPO Pullback setup.

It's a healthy sign if a new issue closes above the open and in the upper half of the day's trading range. A new issue that closes below its open and/or in the lower half of its trading range may face more problems ahead -- even if it's still trading well above the offering price.

Consider Palm Inc.

This was a glamour IPO if there ever was one. The financial news media were all over the spin-off of the manufacturer of the hot-selling handheld Palm Pilot computer from parent 3Com. Meanwhile, Palm assembled a white shoe underwriting syndicate. Investment banking titans Goldman Sachs and Morgan Stanley Dean Witter were the lead underwriters. Merrill Lynch and Robertson Stephens served as co-managers.



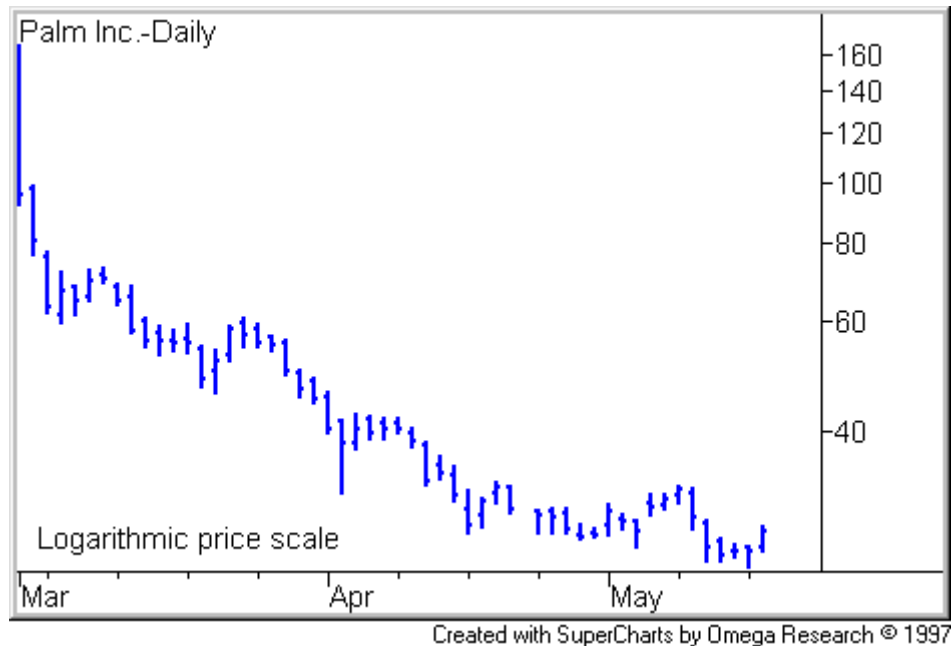
On March 2, 2000, Palm came public in an initial public offering of 23 million shares of common stock at an offering price of \$38 per share.

The stock's debut left a great deal to be desired. As expected, Palm exploded out of the gate, opening at 145 a share, nearly quadruple the offering price. From there, the stock slid downhill. It closed at 95 1/16, well below the open and near session intraday low of 92 5/8.

The stock still qualified -- nominally -- as a Hot IPO Pullback candidate, given that it exceeded the minimum requirement of a 15% advance over the offering price within the first five trading days. But closing before the open and near the session low was a bad sign, especially for so hyped an IPO as Palm.

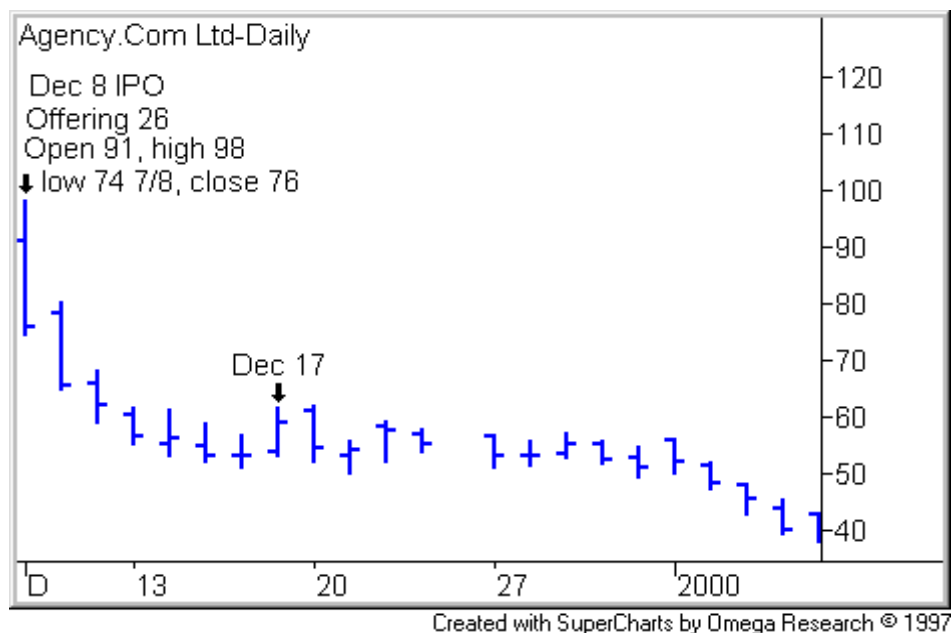
"Palm probably was never a good candidate for a Hot IPO Pullback given what it did the first day, closing so far off its open and its high," Cooper noted. "It pulled back for three days and had a slight bounce. And when it took out the low, the first low, it basically started to tank."

Here's a longer-term view of Palm's performance since the IPO. Not pretty!



Another Cautionary Tale

Another example of a stock that popped high out of the gate, and then collapsed, is Agency.Com Ltd., a firm that helps clients develop Internet businesses. The company came public Dec. 8, 1999 in an initial public offering of 5.9 million shares of common stock, offering price \$26 a share. Big banking guns Goldman Sachs and Salomon Smith Barney served as the lead managers, with Hambrecht & Quist acting as co-manager.



As you can see, Agency.Com shares opened strong at 91, more than triple the offering price, and made an intraday high of 98. Then the stock sagged to a session low of 74 7/8 before closing near that low at 76. In the days ahead, the stock slid further, although it still remained well above the 15% minimum.

Based on that behavior, someone using the Hot IPO Pullback strategy should have been suspicious of this stock when, on Dec. 17, it cleared its prior session high.

Agency.Com continued to trend lower and subsequently cracked below its offering price, the kiss of death for many a new issue.

Where to Look for HOT IPOs

TradingMarkets.com offers an expanded IPO section to help you set up your own target list of new issues. Click on the *Stocks* tab, near the top of the TradingMarkets home page. Then click on the *IPOs* tab. Under IPO Setups, you'll see a link to Hot IPO Pullbacks.

Each night, TradingMarkets.com scans the market for stocks that appear to forming, or are close to forming, Hot IPO Pullbacks. **Depending upon market conditions, there will be many nights where no stocks qualify for the Hot IPO Pullback list, and other nights when stocks fitting the profile are more plentiful. So check the list each night.**

I hope you have enjoyed this week's installment of our course. Next week, I'll teach you an optimal tactic for intermediate-term trades of IPOs -- the first-stage base.

WEEK
—THREE— *Identifying and Trading
First-Stage Base Breakouts* **—**

IPO Entries for the Intermediate-Term Trader

In this week's installment of **Trading Hot IPOs**, I will teach you about IPO entry tactics for the intermediate-term trader. Last week's lesson on Hot IPO Pullback was geared to the short-term trader, who carries positions for a few days at most. You and I now will discuss first-stage and second-stage bases, which are the optimal entry setups for the trader looking to buy a new issue and hold it for a very large percentage gain over weeks or even months.

The beauty of first-stage bases is that you probably already use them! We're going to discuss the use of three patterns -- **Cup with Handle**, **Price Expansion Breakout**, and **Double Bottom**. You use these price-and-volume bases on IPOs exactly as you would more mature stocks.

So what's so special about that? you might ask.

Here's the answer. As you may already know, these bases work well to time buy points in individual stocks during *healthy, uptrending* markets. They work *even better* when applied to new issues under the same healthy market conditions.

A great winning stock typically forms a series of bases over long advances. A big advancer forms a base, moves higher, corrects but holds on most of the prior gains, then recovers, building a fresh base. From that base, it launches again. Look back at such great stocks as Microsoft, Cisco Systems, General Electric, Intel, Yahoo, Home Depot, The Gap, Hewlett-Packard, Dell Computer, Wal-Mart, American Express, Oracle. Each big winner's multi-year ascent was paved with base after base.

The trouble is, once a stock has made four or more successive bases on the road to higher highs, the stock often becomes too obvious in the market place. The stock might continue forging ahead, but the pattern will become looser and more volatile. Too many people are trying to buy off the pattern, or buy just ahead of the pattern.

This added volatility results in traders being stopped out as stocks seem to emerge from a proper base, then pull back, hitting traders' protective price stops, before resuming the advance. It often takes a severe correction or bear market to reset such stocks and restore the efficiency of the base.

This brings me to the great advantage of new issues. Because the stock is a new issue, it's not obvious the public. **Exploiting a new issue's first or second base gets you in early, while the price pattern is vigorous, before the crowd has become enamored of the stock and is discounting every dip and breakout.**

As a result, the first- or second-stage base of a new stock is often among the most powerful entry events for the intermediate-term trader!

Trading Guidelines for New Issue Breakouts

In the next units of this course installment, I will examine real examples of newly issued stocks that generated tradable first- and second-stage bases that signaled clear buy signals just before blasting off for terrific runs. But first, let's set down general principles.

1. The newly issued stock should be in an uptrend or reasserting an uptrend after a correction at the time you buy shares.

2. The market should be in an uptrend or have put in signs of advancing from a bottom after a correction. New issues tend to outperform the broader market during rallies and bulls. So this turns an advancing market into a powerful ally to your trade.
3. Don't buy new issues during adverse markets. New issues suffer even more than the broad market during corrections and bears. Buying new issues in adverse conditions raises the odds tremendously that your trade will end in a loss.
4. If a new issue appears to be forming a constructive price pattern, don't buy if the market is in a down trend, no matter how tempting the chart looks. However, take special note of such a stock. Resilience in the face of a contrary general market could indicate that a stock has genuine leadership potential. When market conditions turn favorable, such stocks can skyrocket! I'll show you a great example -- Terayon Communication Systems -- later in this course.
5. Always set an **initial protective stop** when you buy any stock, new issue or otherwise. For purposes of this course, we will assume an 8% sell rule. In other words, if you buy a stock at, say, 25 a share, you would sell if it falls to or below 23, depending on your convention.

If you employ more elaborate stop-setting techniques that balance money management and stock volatility criteria, so much the better. Use what works for you. William O'Neil, founder of **Investor's Business Daily** and the man who named with cup with handle pattern, has recommended a 7-8% initial stop for CANSLIM trading. I've personally found that an 8% initial stop and does a good job keeping you in successful trades while getting you out of harm's way when a stock reverses against you with a minimum of stop-outs.

6. Once a new buy has advanced far enough to produce a profit worth protecting, switch to a **trailing stop** or some other type of selling regimen that will allow you to ride out normal volatility but will force you to take profits if your gain is threatened. Selling is a whole universe worthy of its own course. If money management and loss-cutting considerations are new to you, read the second part of my course. It will introduce these concepts and refer you to other educational resources on selling and money management.
7. A little vocabulary. Some traders use the term **breakout** to refer only to a break above a previous trading range that also coincides with a new all-time price high. That's certainly a breakout. But I am going to use the term **breakout** to refer to any price move that takes a stock above a key pivot point or trading range and produces a buy signal.
8. Day traders and short-term traders seek to exploit price moves that last minutes to a few days. So they use price patterns that last minutes to days. A like-minded sensibility should apply to intermediate-term traders. If you are looking to stay in a position for a number of weeks, you should look for price structures or bases of some weeks to months in length. I insist on bases of at least five trading weeks -- i.e., 25 trading days -- in duration.

A final note: I've tried to write this so any subscriber coming to our site can immediately benefit. I explain every term that you need to know. I'll back up the theory with real trading examples.

However, please permit me one friendly word of advice. If you plan to trade new issues for intermediate-term time frames, you should do so within the context of an overall intermediate-term trading strategy. If you have not done so already, you owe it to yourself to read Greg Kuhn and Kevin Marder's *Intermediate-Term Momentum Trading* course, available to all one- and two-year subscribers to TradingMarkets.com, and William O'Neil's *How to Make Money in Stocks*.

Now, let's get on to my favorite trading pattern -- the Cup with Handle.

Cup-with-Handle Basics

Like many intermediate-term traders, the cup with handle is my favorite trading pattern. I love it for three reasons. First, the price structure makes sense to me. It corresponds to the natural cycle of greed-to-fear-greed that lies behind cycles of correction, recovery and advance in individual stocks. Second, the cup-with-handle recurs rather frequently among leadership stocks compared to other bullish patterns.

Most importantly, the pattern really works. I've traded it many times. Some trades failed, either stopping me out before the stock ran higher or stopping me out before the stock collapsed. But the pattern still produces more than enough successes to justify the losses. And it works despite having been extensively publicized by **Investor's Business Daily** and described by William O'Neil in his best-selling classic, *How to Make Money in Stocks*. TradingMarkets.com also lists stocks making cup-with-handle patterns on the Web site.

Despite this extensive attention, the darn thing keeps on working! If you were going to learn only one intermediate-term pattern, I'd tell you to learn the cup with handle.

I like to refer to patterns like the *cup with handle* and the *double bottom* as **correction-recovery patterns**. As a momentum trader, you buy stocks in uptrends. But just buying a stock because it's rising is a recipe for failure. A great number of your trades would be followed by pullbacks due to profit-taking. You would get stopped out of a high percentage of your new buys as your stocks triggered your initial stops.

So the idea is to allow the stock to under go a real correction, one that stretches for a number of weeks before the stock bottoms and resumes its upward course. That's the **cup** part of the cup with handle. The stock puts in a U- or cup-shaped price formation from pre-correction price high, to decline (the left side of the cup), to bottom, to recovery toward its former high (the right side of the cup).

The recovery phase should include price gains on strong trading volume. This indicates that powerful institutional investors -- like hedge funds and mutual funds -- and buying up shares. That kind of support is necessary to continue driving the stock higher.

Then comes the **handle**. Once the stock has made up at least half the ground lost from pre-correction intraday high to the intraday low of the bottom of the cup, the share price should start to trade sideways. In fact, the handle should gently drift lower, as defined by the intraday lows of the cup the handle. This indicates that the last would-be sellers are exiting the stock.

You want these people to sell! You don't want them selling after you buy. You want them to hold tight. That way, when heavy demand for the stock comes to market, the buyers who come after you are obliged to bid up the stock in order to entice sellers. That propels the share price higher.

However, the **selling in the handle should remain muted**. You want evidence that most shareholders are content to hold onto their shares at the current market price. So the underlying trading volume should be subpar when compared to the stock's recent trading history.

Your **pivot point** is the highest high of the handle. Instead of continuing to drift downward, the stock suddenly bolts straight up. You buy as the stock exceeds the high of the handle by 1/16 of a point.

This point is lost on some people who think that they should buy only when the stock makes an absolute new high. Not so. If a stock makes a new high at the same time it clears the high of the handle, that's very bullish. But this is not required.

Just make sure that the handle forms above the stock's **mid level**, the point where the stock has made up at least half the loss of the prior correction. The reason for this rule has to do with something called **overhead supply**, a concept I first learned reading O'Neil's *How to Make Money in Stocks*.

Overhead supply is the portion of a company's outstanding shares that rest in the hands of **weak holders**, investors who acquired their shares at higher prices. Many of these shareholders will feel inclined to sell into rallies, sapping the strength of upside moves.

Once a stock has recovered at least half the ground lost in a correction, the problem of overhead supply begins to diminish as the remaining weak holders, cheered by its recovery, grow more confident in the stock's prospects. To find that mid level, just sum the pre-correction intraday high with the subsequent intraday low of the correction. Then divide by 2.

If the newly issued stock has been trading more than 50 days, the handle should form above the stock's 50-day moving price average. This is another safeguard against overhead supply.

William O'Neil also argues that the breakout -- when the stock is surging above the high of the handle -- should come on strong trading volume. I couldn't agree more. However, as a practical matter, I must admit that I often buy without clear signs that the day's trading volume is going to exceed the norm.

If the breakout occurs early in the day, you may not know whether volume is exceptional until hours later. By then, the share price might have flown too far, leaving the stock vulnerable to a pullback. If the trading *seems* brisk to me, just by eyeballing the number of trades and the size of position sizes changing hands, I'll buy and hold so long as the stock does not violate my initial stop.

You also can try to extrapolate first hours of volume into the full trading session. This is an imperfect solution. Trading volume is not evenly distributed throughout the session. You generally get big bursts in the early and late sessions. But it works for some traders.

Don't chase stocks too far. Once you've identified your pivot point -- such as the high of the handle in a cup with handle -- buy as soon as the stock sends a buy signal. Don't let the stock extend more than 5% beyond its pivot point. Many cup-with-handle breakouts will pull back after breaking out. You want to get in soon enough so that the pullback doesn't trigger your initial protective stop.

If one of these gets away from you, you can buy if there's a pullback if it comes back within 5% of the pivot. Volume should be light on the pullback, and the stock must not invade its old base.

Finally, cup-with-handle patterns tend to come out of the woodwork in regular growth stocks at market bottoms and as the market launches on a fresh rally. When you're seeing lots of other stocks form sound cup-with-handle bases, the odds are probably good that you're in a healthy market, and that the pattern will work when applied to new issues.

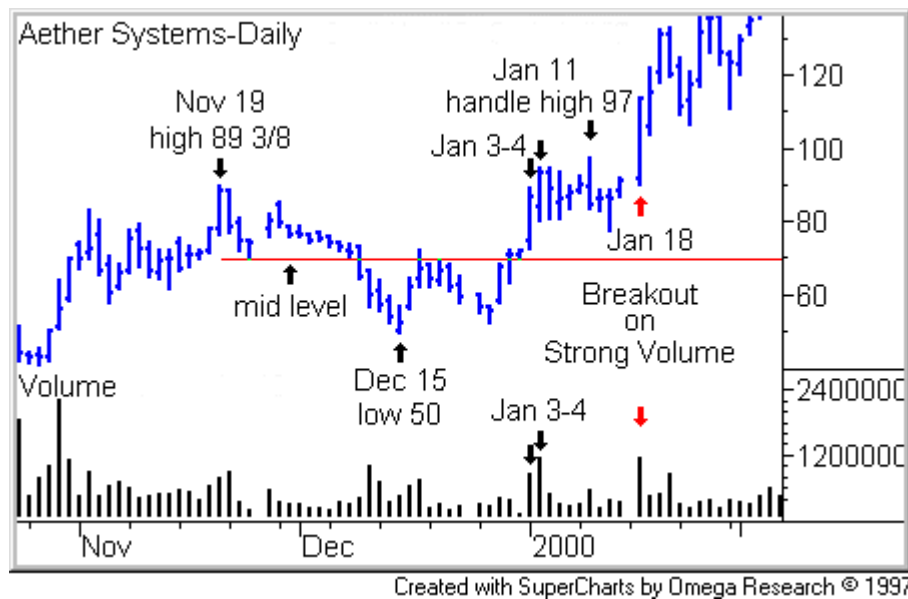
As rallies become aged, extended and near their tops, you'll see fewer and fewer cup-with-handle patterns and other sound bases. Stocks will look increasingly extended, move highing out of increasingly short patterns. Breakouts fail more frequently. That kind of market action should raise the hair on the back of your neck. It should cause you to think twice about buying new stocks, even those forming tempting bases.

Now, let's look at our first example of a Hot IPO blasting off from a cup-with-handle pattern.

Aether Systems

Aether Systems came public on Oct. 21, 1999 at an offering price of 16 a share*, opening at 50 on its first day of trading, consolidated three more days, then headed higher until making a Nov. 19 intraday high of 89 3/8.

Here's the chart. All offering and market prices are split adjusted.



From the Nov. 19 high, Aether shares entered a correction over the next 17 trading days until recording the lowest low of the decline at 50 on Dec. 15.

As you can see, the stock tried to recover over the next four trading days, then sank back. That's good. You don't want to see cup-with-handle stocks immediately bounce back, forming a V-shaped correction-recovery pattern. Such sharp recoveries leaves a stock prone to profit-taking. You want more of a U- or cup-shaped recovery to allow time to replace the weak holders.

The stock needs time along the lows to wear out the weak holders. And little failed recoveries can help push them out as well. Outta there, weak holders! Get out of my way! It's a ruthless world, isn't it!

Once the stock does recover, you want to see the stock advance on strong trading volume. Aether charged ahead on Jan. 3-4, 2000 on surging volume.

This indicates lots of new blood entering the stock, new shareholders who have bought after the carnage, who have an interest like you in seeing the stock advance still further before they exit.

A high volume advance also indicates improving **institutional sponsorship**. In other words, the stock is coming back in favor with the big institutions -- pensions, bank trust departments, hedge funds and mutual funds -- who dominate the markets. Their powerful buying power is absolutely critical if a stock is to make a really powerful advance.

As Aether climbed the right side of the cup, it crossed above and pulled well above its **mid level**. You can find Aether's mid level by summing the stock's pre-correction high of 89 3/8 with its correction low of 50, totaling 139.375, then dividing the result by 2, yielding a result of 69.6875, or just a hair shy of 70 a share.

Finally, volume trailed off, but the stock continued to hold its own and move sideways, beginning the handle. The high of the handle was formed on Jan. 11 when the stock hit an intraday high of 97.

Two days later, the stock broke to a new low, but then recovered to close in the upper end of the range. While you want to see the handle tighten and become less volatile before the breakout day, this kind of brief spike can be constructive. Probably a last batch of weak holders jumped out of the stock, but healthy demand rushed in to take advantage of the bargain at the lows, supporting the stock.

Then on Jan. 18, strong demand hit the market, visible in surging trading volume, and the stock took off. Your pivot point would have been the Jan. 11 handle high of 97.

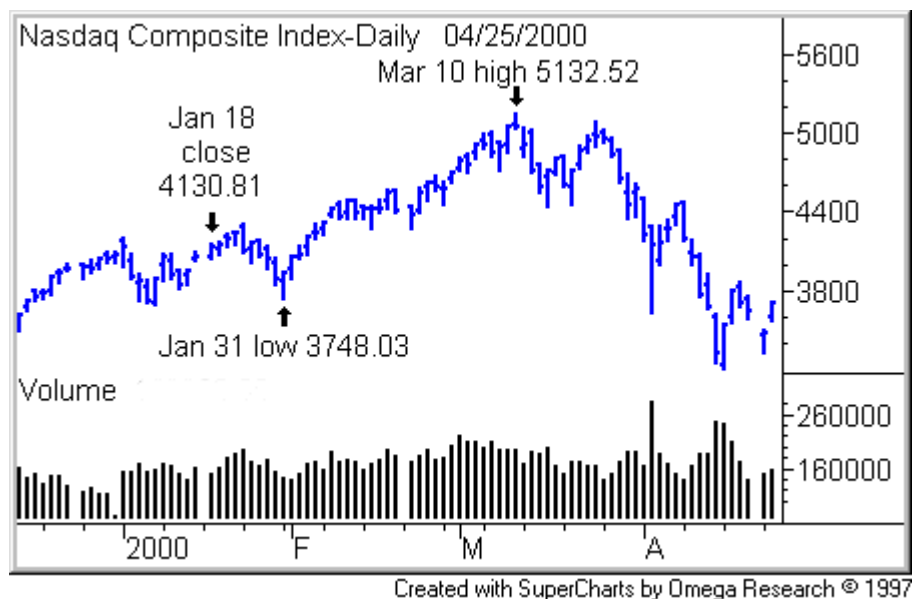
You should have entered your buy order as soon as the stock saw 97 1/16 on the bid. But let's say you were slow on the trigger or your order was somehow delayed. You're filled at, say, 101 7/8, just about at the limit of your 5% buying zone beyond the pivot point. Setting your stop at 8% of cost, you would have set your initial protective stop at about 93 3/4.

In this case, you would have enjoyed the stock's ride to a Jan. 18 close of 113 3/8. And you would have had a nice profit cushion the next day when the stock pulled back to an intraday low of 104. From there, Aether Systems enjoyed a terrific run until topping on March 10, 2000 at an intraday high of 345! Just staying in for a part of that move would have been very rewarding!

Of course, this chart also shows the importance of using **trailing stops** or some other **profit-taking** regimen to lock in your gains!



By the way, note how Aether's top coincides exactly with the top in the Nasdaq Composite Index.



This is no minor detail. Again, the IPO market and subsequent new issues are extremely sensitive to general market conditions. Like Robert Natale, an expert on IPOs has said, when the stock market catches a cold, IPOs get pneumonia. We'll talk more about IPOs and market conditions later in this installment.

* All offering and market prices in this course, unless stated otherwise, are adjusted to account for splits as of April 2000.

eBay Away!

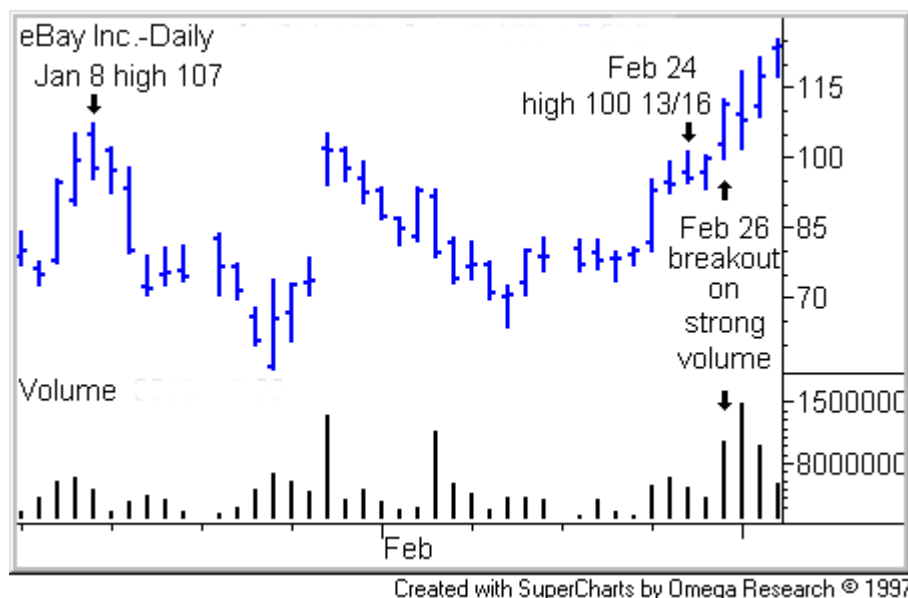
You'll recognize this name, of course. eBay was one of the quintessential .com startups. The company brought the garage sale auction to the Internet, overnight creating an enormous unified marketplace. Like Aether Systems, eBay's first-stage base was a cup with handle.

One could argue that eBay broke out of its first base on Oct. 26, 1998. The price structure even had traits of a cup with handle. However, the pattern lasted only 23 days from pre-correction high to breakout. That's a tad shy 25 sessions, which I regard as the bare minimum for an intermediate-term trader. So that price structure didn't meet my definition of an authentic base.

Also, on the breakout day, the stock gapped up so high that opened more than 9% above where one would define the high of handle. The stock took off from there and never looked back, thus never giving a trading operating under my rules a chance to climb aboard -- yet!

Be patient. Don't ignore your buy rules to chase extended stocks. Don't ignore your sell rules to keep you in falling stocks. Many times, the ones that got away give you more than one chance to take a position. And that was the case with eBay.

eBay vaulted higher, passing through no fewer than five trading ranges or zones. None lasted quite long enough to qualify as bases by my rules. The patient trader would have been rewarded. eBay at last formed a proper cup with handle.

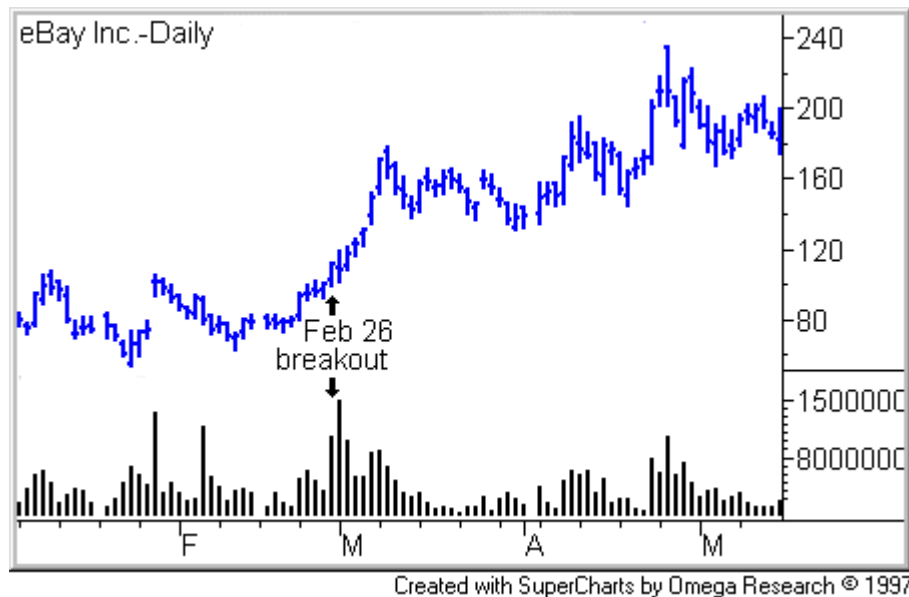


After tagging a Jan 8, 1999 high of 107, eBay shares went into a severe correction before market a bottom of about 55 3/16 on Jan. 22. This marked the stock down through two previous trading ranges. Few people who bought earlier could or should have held on through such carnage.

The stock tried to recover immediately from its Jan. 22 bottom, but the market slapped down this premature comeback. As I said, this is healthy activity. You don't want a failure-prone V-shaped bounce-back. The stock needs time to shake out the weak holders.

eBay's chart is instructive because it shows how brief handles can be. As eBay recovered, the stock made a post-correction high of 100 13/16 on Feb. 24, 1999. Then it paused for just one day before shooting ahead on powerful volume.

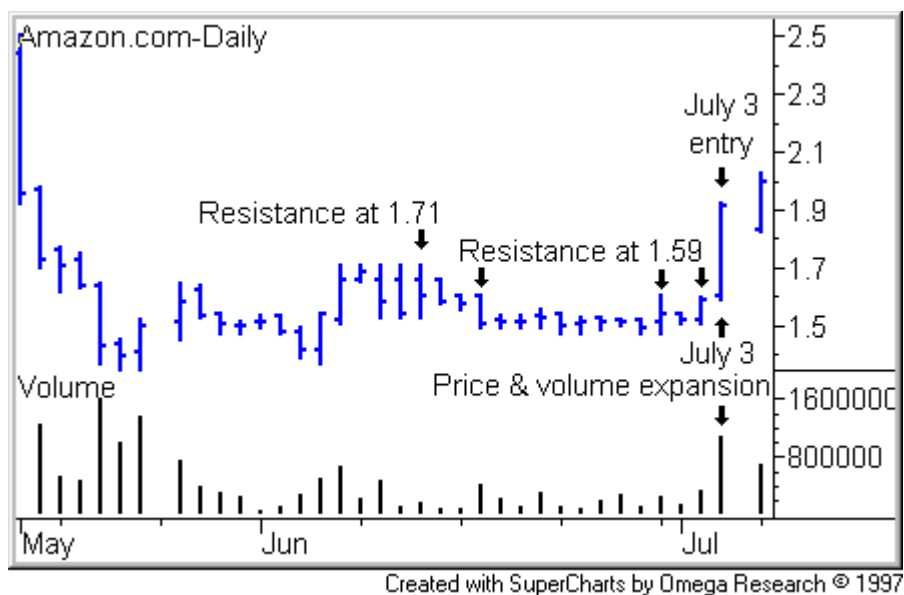
Your pivot point was 100 13/16. Your buy point was 100 1/2. Again, don't waste time. These stocks can move and extend very quickly. Let's say, though, you got filled at 104, implying considerable drift. Using an 8% stop, that would put your defensive sell price at around 95 5/8. Ample room to keep you in the stock until switching to a trailing stop.



Price Expansion Breakout

A stock doesn't have to trace a textbook base to reveal tradable clues. Often just looking for resistance levels can reveal buy points in the event a new issue comes alive. Amazon.com, the Web-based book and music retailer, stands as a great example.

Because Amazon has gone through a number of splits since coming public, I've had to resort to decimal figures rather than the fractions of 1/2, 1/4, 1/8 and 1/16 more familiar to traders. Again, all offering and market stock prices in the text and charts of this lesson are split-adjusted.



The chart shows Amazon.com's trading behavior from the day of its IPO over the next 34 days of trade. Notice how after the first couple days of trading, stock sort of funnels into a progressively tighter trading range, including fairly consistent but tightening resistance ceilings.

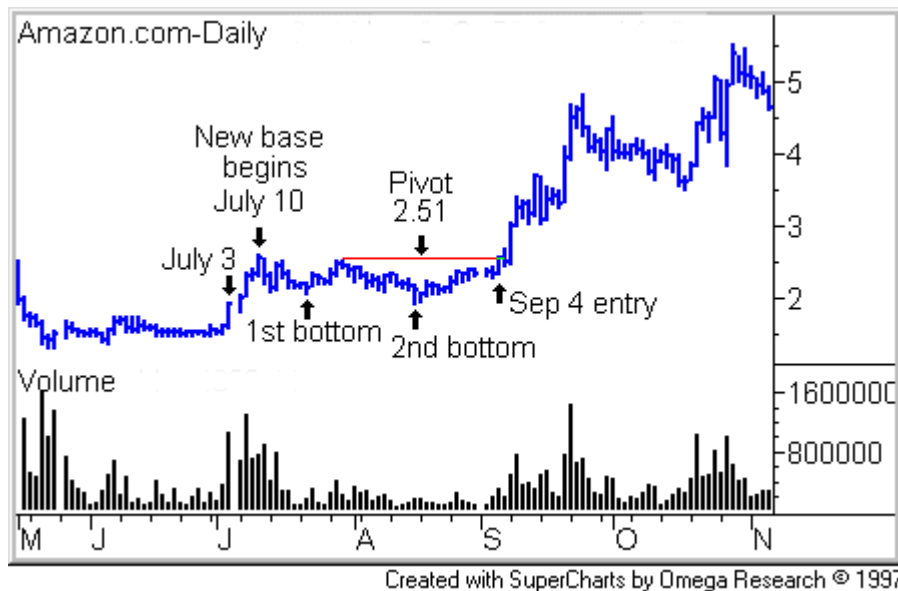
When a stock repeatedly meets resistance near the same price level, but refuses to give up much on the pullback from resistance, something akin to a coil spring may be taking place. Demand for shares is pushing the stock higher, but sellers or short-sellers keep coming to market at that level. Once the stock moves above that resistance, demand has shown its getting the upper hand over supply.

The signal is even more reliable when the **price expansion breakout** occurs on a **volume expansion**. And that's exactly how Amazon acted on July 3, 1997. The buy point comes as the stock clears the prior resistance point.

Second-Stage Base

Often a great base only looks like a great base in hindsight, once the stock has advanced off the prior platform. Don't kick yourself for missing an opportunity. Look for the next opportunity. New issues often form a new base right on top of the old one, rather than running for months. These second-stage bases still occur very early in a big advancer's great run. They are about as productive and efficient as first stage bases.

Amazon.com formed a double-bottom base soon after its July 3, 1997 breakout.



Notice how Amazon did not invade the earlier trading range when the second-stage base formed the *second bottom*. That's constructive. Even with the correction, the stock is holding onto its past gains. Now let's analyze Amazon's **double-bottom base**.

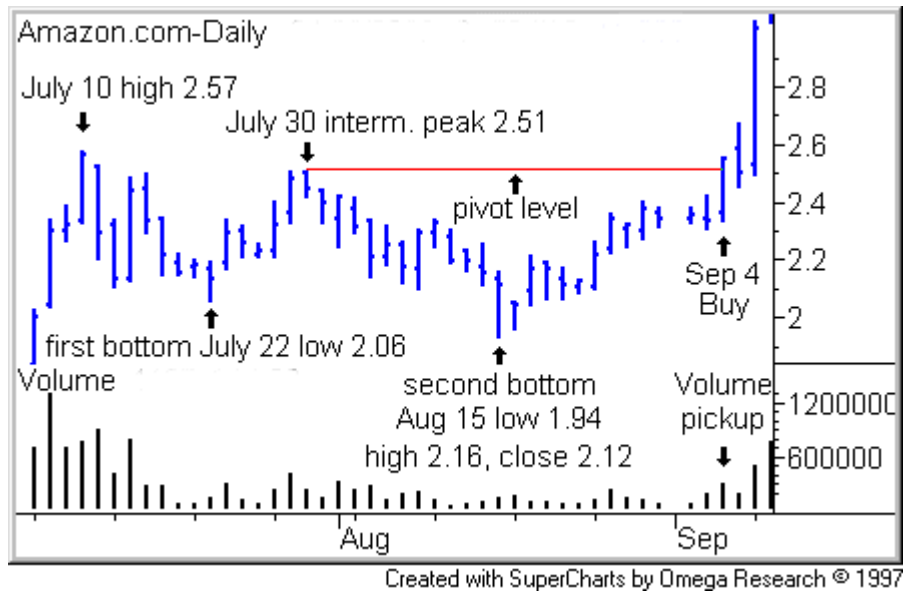
Double-Bottom Base

Sometimes, a winning stock will enter what appears to be a normal correction, then start to recover. But the stock never reaches its pre-correction high. Instead, it peaks somewhat below the old high. The stock stalls at this *intermediate peak*, then falls again, dropping to even lower levels.

At last, the stock recovers for real. Your first pivot point lies at the intermediate peak. Buy as the stock clears that level by 1/16 of a point.

This pattern is called the **double-bottom base**. It occurs less frequently than do price-expansion breakouts and cup-with-handle patterns. It's also known as the W pattern because the price structure sketches a profile resembling that letter of the alphabet.

Let's take a closer look at Amazon's double-bottom base. Again, apologies for the use of decimalized stock prices.



As you can see, Amazon rose to a high of 2.57 on July 10, 1997, then entered a volatile correction before making a July 22 low of 2.06. From there, the share price tried to recuperate but stalled and fell again after a July 30 intraday high of 2.51.

The share price resumed its correction, this time breaking below the old July 22. The stock formed its second, lower bottom on Aug. 15, making an intraday low of 1.94.

This second, **lower** low is a distinguishing factor in the double-bottom base. If you look back at the cup-and-handle charts of eBay and Aether Systems, both stocks fell, tried to rally back, then fell again. But eBay and Aether did not form lower lows on the second trip down. On the other hand, Amazon did form a lower low on the second decline.

You could see healthy activity in the Aug. 14 session. After tagging the intraday low of 1.94, the stock shot back up to close at 2.12, very close to its intraday high of 2.16. That's a sign that bargain hunters were rushing in to buy shares at those lows.

As Amazon headed north, we would look to the July 30 intermediate peak as our pivot point. As with cup with handle patterns, you don't want to buy a stock weighed down by overhead supply. Fortunately, Amazon's mid level -- the point where the stock had made up half of the loss from pre-correction high to correction low -- was at 2.26 in this case (high 2.57 + low 1.94, then divide the sum by 2).

The July 30 intermediate peak of 2.51 sits comfortably above the mid level. So the intermediate peak qualifies as a reasonable pivot point. Amazon shares cleared the pivot level on a bullish increase in trading volume on Sept. 4.

IPOs and Market Savvy

As I've said before in this course, new issues tend to outperform the market during rallies and bulls, and they do terribly in corrections and bears.

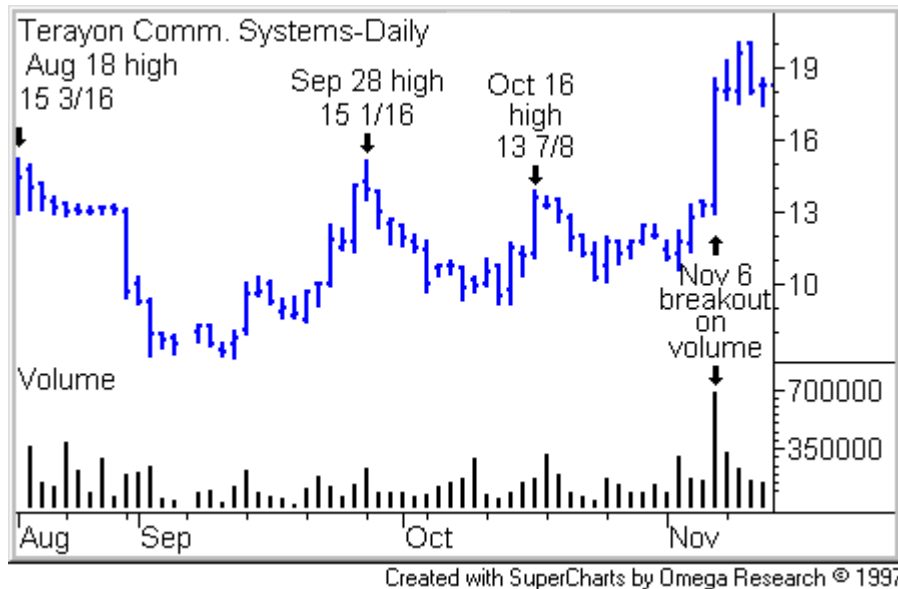
This does not mean to take your eyes off new stocks during a downturn. Quite the contrary! Adverse markets provide an excellent opportunity to spot future leaders. When a stock holds its ground while other stocks are getting creamed, that's a sign of exceptional strength. Once the contrary market pressure comes off such a stock, it can really pop!

In my opinion, when a **new issue** stands its ground in such conditions, that's even more impressive. After all, the new issue is supposed to be more vulnerable trying times.

The key is to keep such rare stocks in your sights. Don't buy with the market against you. But ready to snap up shares if the market turns around, and the stock responds.

Let's look at an example.

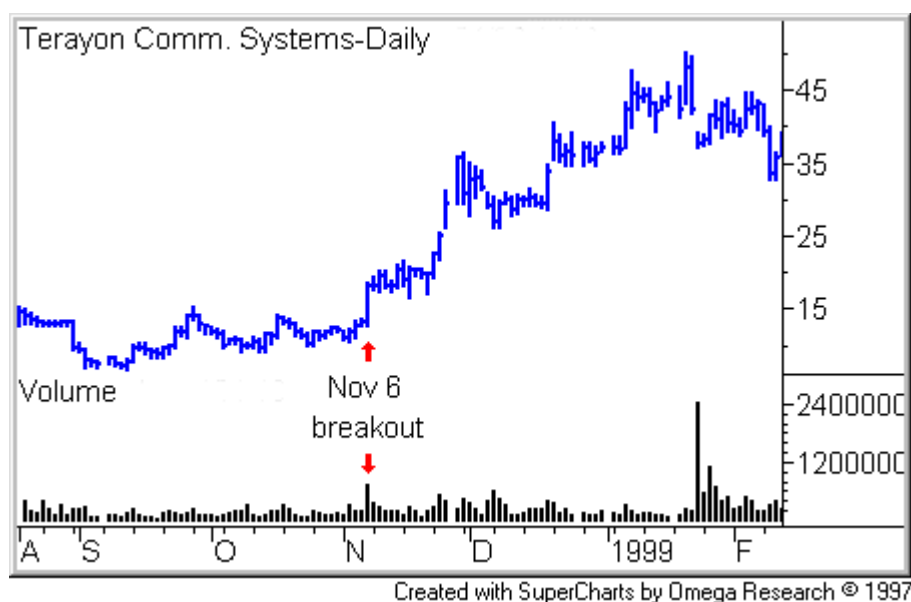
Terayon Communication Systems had the misfortune to come public as the stock market was beginning what would later become the bear market of the summer of 1998. The market topped on the Nasdaq Composite on July 21, 1998. Terayon's initial public offering took place on Aug. 18 of that year.



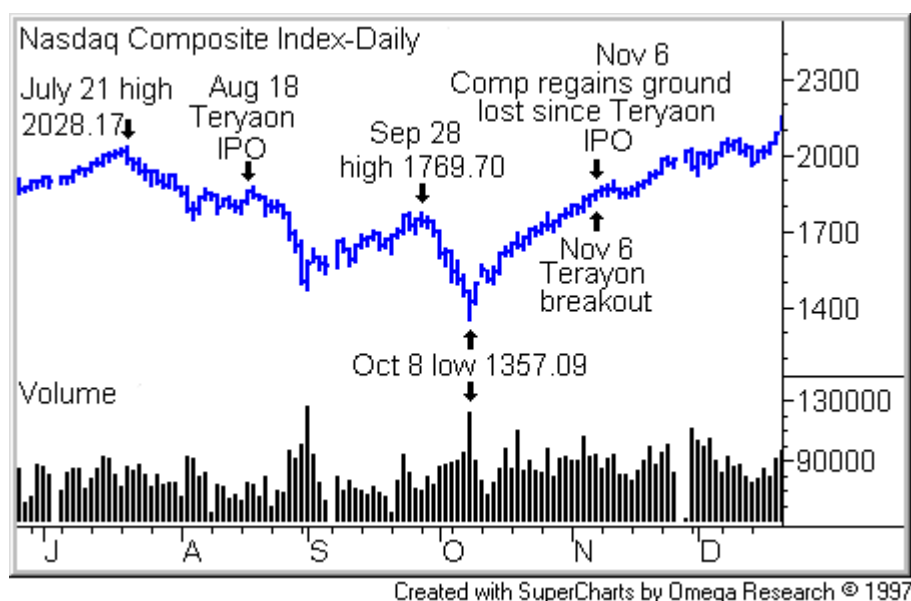
As you can see, Terayon made an all-time high of 15 3/16 on its IPO day, then soon sold off. Shares staged an initial comeback, topping at 15 1/6 on Sept. 28, 1998 such adversity marks a significant departure from the norm. At the same time Terayon managed this attempted recovery, the Nasdaq was rallying as well. Like Terayon, the Nasdaq Composite also made peak on Sept. 28. Then both Teryaon's share price and the Nasdaq Composite headed lower.

Unlike the Nasdaq Comp, Teryaon did not fall to lower lows. And as the market rallied off its Oct. 8, 1998 bottom, Terayon tried to rally as well. The stock, however, still ran into profit-taking pressures as it rallied, falling back from resistance after making a high of 13 7/8 on Oct. 16. But again, when the stock fell back, it refused to give up as much as before, bullish action similar the Amazon.com price-expansion breakout.

By now, a vigilant trader would see that Terayon's test point was its Aug. 18 all-time high of 15 3/16, shares made that resistance level obvious when they fell back just below that level on Sept. 28. That would have been your pivot point in the event of a price expansion breakout. On Nov. 6, Terayon smashed through that level on huge volume. From there, it was off to the races.



There's one more observation to make about Terayon that I think drives home the value of watching stocks in conjunction with the market. Terayon's Nov. 6 breakout corresponds *to the day* that the Nasdaq Composite made up all the ground since Terayon's IPO on Aug. 18!



I hope you've enjoyed this week's installment of **Trading HOT IPOs**. Next week, we'll turn to a powerful technique for short-selling new issues.

WEEK
FOUR

Shorting the Hype

Shorting New Issues

Welcome to Week No. 4 of my course, *Trading HOT IPOs!*

So far, I've shown you two powerful trading tactics: the Hot IPO Pullback and the first-stage base. These are setups for **long** trades, buying shares in an effort to profit from a subsequent price advance in a newly issued stock.

Of course, stocks and stock markets don't always rise! Stocks also break down and decline. In this part of our course, I am going to teach you a powerful tactic for making money on the downside of newly issued stocks.

In our case, that means **short-selling**. In a short sale, you borrow stock from your broker and sell it in the expectation that it will fall in price. If all works according to plan, you buy back those shares at a lower price, returning them to your broker and pocketing the price difference as profit.

I am going to teach you a short-selling tactic that exploits one of the most bearish events that can hit a newly issued stock.

When a new issue breaks below its **offering price**, history shows this event tends to spell big losses shareholders who stay in the stock. The stocks that break the offer often tank soon afterward if not immediately.

But what's bad for shareholders is good for you, the short-seller! Under the right conditions, the break below offer is your signal to pounce.

In a nutshell, here's how it works:

Look for stocks that rose after the offering and, 30 days or later, break below the offering price. This is where you short them with a 10-15% initial protective stop.

I'll take you through this tactic in detail, step by step. I'll lay out the rules for shorting new issues. Then I'll guide you through a series stock charts, showing you real examples of new issues that cracked below the offer and made money for the shorts.

The Syndicates & The Hype

I call this week's installment **Shorting the Hype** because new stocks receive a huge amount of coordinated promotion and marketing by their underwriting syndicates.

The team of investment banks and brokerages that forms a syndicate sets loose an army of sales people to promote the offering to their clients. The biggest beneficiaries of this campaign are the institutional investors, mainly the mutual funds.

The underwriters depend on the enormous buying clout of the institutions. To persuade institutions to buy IPO shares, the underwriters offer allocations of stock at the choice **offering price**. The offering price is deliberately set below where the underwriters believe the stock will open on its first day of trading. On average, the underwriters try to price initial public offerings about 15-16% below the expected open.

As a result, most institutions buy at the offer with the intention of **flipping** their shares. In other words, they sell their stock right away in the aftermarket, benefiting from the demand whipped up by the promotional buzz created by the syndicate itself. If all proceeds as planned, the institutions pocket the quick profit built into the offering price.

The underwriting syndicate takes another very important step to ensure the institutions make an early, safe exit. **In the first days of trading, the syndicate commits to support the stock price.** If a new issue threatens to fall below the offering price, the syndicate will step into the market and use its own capital to buy shares, defending the stock at the offer.

This artificial support only lasts so long. Eventually, the underwriting syndicate will cease its support of stock, in most cases in a matter of days or a few weeks. Meanwhile, the buzz around the IPO fades, and the newly public company must cut it on its own.

Many new issues that surge high above their offering prices will fall back to earth. What happens if the new issue falls far enough to break below the offering price? This often proves a **deadly development** for a stock.

After all, the offering price supposedly represented a safe bet for the some of the most sophisticated players on Wall Street, the elite and powerful institutions that got in on the initial deal. Cracking below that price often entails a further collapse in shareholder confidence and market perception.

The time has come to short the stock -- provided the breach below the offer occurs at least 30 days after the IPO. By then, most underwriting syndicates will have ceased market operations to defend the stock at the offering price.

Short-Selling

There are two basic ways to make money off a price decline in a stock. You can buy **put options** on the stock. Or you can **short-sell** the stock itself. We will deal with short-selling in this course.

Short-selling first requires that you establish a **margin account**, an account that enables you to borrow stock from your broker.

Now let's say you determine that a stock is probably headed for a big decline. You decide to short the stock. You borrow 100 shares of the stock from your broker and sell it at the market price, say at 20 a share.

Imagine that you're correction. The stock falls in price. It drops to 16 a share. At this price, you buy back 100 shares. This is called **covering your short**. Your broker gets back the stock. You pocket a 20% profit -- minus interest and commission costs.

What if you're wrong, and the stock rises? You lose money. Eventually, you must buy back the shares for more than you sold them for.

So you must have a loss-cutting plan, an **initial protective stop** to prevent a trade from inflicting a harmful loss to your account.

In the case of short-selling, the stop is set at a price at some percentage level above the price where you sold your borrowed shares. **If the stock rises to your stop, you will buy back the shares, taking a small loss to prevent the trade from turning into a big loss.**

I'll go into greater detail about stops further in this installment. For more information on the general subject of short-selling, read Dave Landry's lesson, [Shorting Stocks: The Art of Playing Both Sides of The Market](#).

Protecting Your Capital

Be disciplined about enforcing your stop-loss measures! Over the course of a trading career, you'll make many mistakes. The best professionals have losing trades. The key is keeping losses small, living to fight another day until you catch the big winners, which you let run.

When a shorted stock hits your stop, don't indulge hopes that the stock will decline and prove you right. That's the slippery slope to a big fat loss. You may get away with this dangerous, amateurish practice on a few trades. But eventually, the odds are great that a deteriorating position will inflict a severe loss on your account.

When a shorted stock hits your stop, immediately buy back the shares and cover your short.

A final friendly word of advice: **Never trade without a sound money-management approach for cutting losses, taking profits and sizing your positions.** If these considerations are new to you, check out the chapters "Cutting Losses," "Initial Stops" and "More Reading to Protect Your Account" in Week 2 of this course.

Now let's dive into the brass tacks of shorting new issues.

Operating Instructions

Here are the rules for shorting new stocks that break the offer:

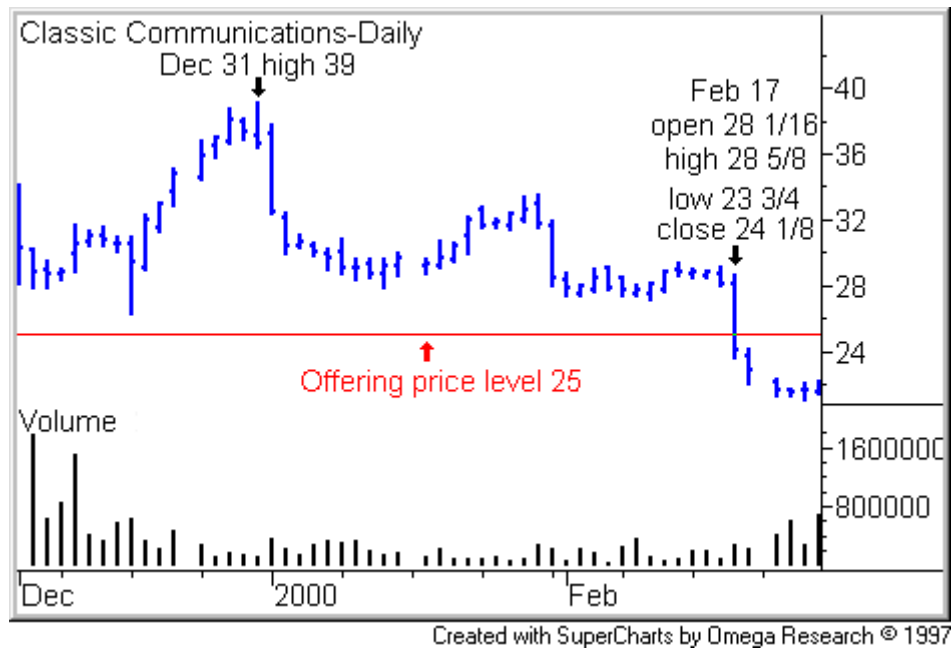
1. Look for stocks that rise after the initial public offering, then enter a decline. This advance-decline shift signals a possible bearish change in character for the stock. A positive uptrend has given way to a negative downtrend.
2. Don't short until a stock has traded for at least 30 days. When you short a stock, you want buyers on the run. You don't want a powerful institution or set of institutions coming in to buy shares and supporting the price or, worse, lifting the share price above your entry price. By the time 30 days have elapsed from the IPO, most underwriting syndicates will have ceased price-support operations in the aftermarket.
3. When a stock satisfying rules 1 and 2 undercuts its offering price. The more you allow a stock to sink below the offer without acting, the more potential profit you give up. Such delays also make you more vulnerable to getting stopped out if the stock bounces back before heading lower. Do your homework ahead of time and trade decisively.
4. As soon as you short a stock, set an initial protective stop, a price level at which you will cover your short and take a small loss, preventing a big loss, if a position reverses to the upside. This course uses a 15% stop. For instance, if you short-sell a stock at 20, locate your stop at 23.
5. Protect your capital by regulating your position size in each individual trade. Wherever you set your stop, your maximum allowable loss should never exceed more than 2% of the total value of your trading account. Many veteran traders set that maximum at 1%. For more on this topic, read my tutorial, [Risky Business](#).
6. Take profits on the way down. Don't try to pick bottoms. Once you have a profit worth protecting, lower your stop. From that point forward, use a trailing stop, keeping you in the stock if it falls further, but stopping you if the stock reverses to the upside.
7. Once you have a 25% profit in a short, lower your stop to at least your breakeven point, which should be at or very close to the offer.
8. While there's no theoretical limit to how far a stock can rise, there is a limit to how far a stock can fall. It's zero. Consequently, the further a stock declines, the less further profit awaits you ahead. So don't get greedy. As a stock falls further, don't just trail your stop lower. *Tighten* your stop as well.

Now, let's analyze some real-world examples of shorting new issues.

A Classic Short

Classic Communications came public Dec. 8, 1999 at an offering price of \$25 a share. Based in Austin, Texas, the company operates a cable network providing television and high-speed Internet access in non-metropolitan markets in the U.S.

The following daily chart shows Classic Communications from its initial public offering through the short-sell signal.



The stock opened at $30 \frac{3}{4}$, gyrated between an intraday high of 34 and an intraday low of $28 \frac{1}{4}$, and closed the first day of trading at $30 \frac{5}{16}$. Not uncommon volatility for a new issue on its first day of trading. The mix of excited, often naive after-market buyers and flippers can create a real free-for-all between supply and demand. I'd never step into the middle of a fight like that!

After several consolidation days, Classic Communications shares began climbing. The stock peaked on Dec. 31, 1999 and entered a sharp slide.

So far, this is what you want to see in possible short candidate -- an advance over a number of trading days, followed by a downtrend. A bearish personality change in the stock.

By Feb. 16, 2000, Classic Communications had traded for 49 sessions, satisfying the minimum 30-day requirement for our short-selling setup.

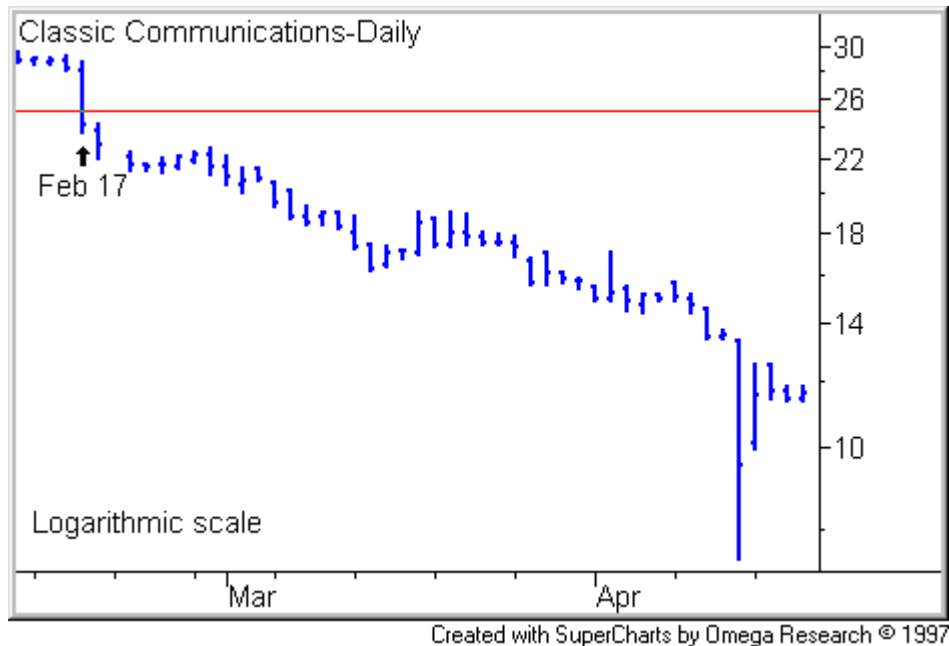
On Feb. 17, the bottom opened under the stock. Classic Communications shares undercut recent support, then punctured recent support at $27 \frac{1}{4}$, then broke below the stock's all-time low of $26 \frac{3}{8}$.

Both levels would have been good places for you to have set real-time price alerts. You would have been ready to pull the trigger when the stock broke below its offering price of 25.

At that point, you short the stock and set your stop-loss. A 15% stop-loss would set your stop at $28 \frac{3}{4}$.

Cashing In

Classic Communications didn't put up a fight. As soon as the stock pierced below the offer, the share price just collapsed.



Once Classic Communications broke the offer, you would have faced a new problem. At any point on the way down, should you stay in, hoping for the stock to fall further and produce greater returns? Or should you buy back the shares, foregoing the shot at greater gains but banking a real profit?

I recommend that once you have a 25% profit in a short, lower your protective stop to your break-even price. In this course, we'll assume you shorted at the offering price.

So once Classic Communications fell to 15 a share, I would lower my stop to 25.

My reasoning here is twofold. First, if the stock rallies back, this keeps the trade from turning into a loss. Second, I've often seen the offering price serve as a resistance point. New issues sometimes will rally back soon after a serious breach of the offering price. Then they'll stall just short of the offer and roll over and die.

Once you've lowered your stop to the offer, you can use a trailing stop to follow the stock south until it reverses enough to stop you out at a profit.

However, keep this in mind. There's no theoretical limit to how far a stock can appreciate. But there is a limit on how far a stock can decline -- zero. The closer a stock moves toward zero, the less the short-seller stands to reap on further declines.

So at some point, you should consider covering your short and taking profits. It doesn't have to be an all-or-nothing proposition. You can cover half your short once a paper profit looks juicy enough, letting the remainder ride below a trailing stop if the downtrend still looks intact.

A Note about Charts

You may have noticed that I plotted Classic Communications using two different scales. The first Classic Communications chart used on an *arithmetic scale*, also called a *linear scale*. The second chart used a *logarithmic scale*.

Over short time frames of a few weeks or even months, simple, arithmetic charts work fine. But over longer time frames, an arithmetic or linear scale can distort the compounding picture of a major price decline or advance.

For instance, on a linear chart, a price move from 10 a share to 20 plots over the same distance as a price move from 100 to 110 (assuming each move occurred over the same span of time).

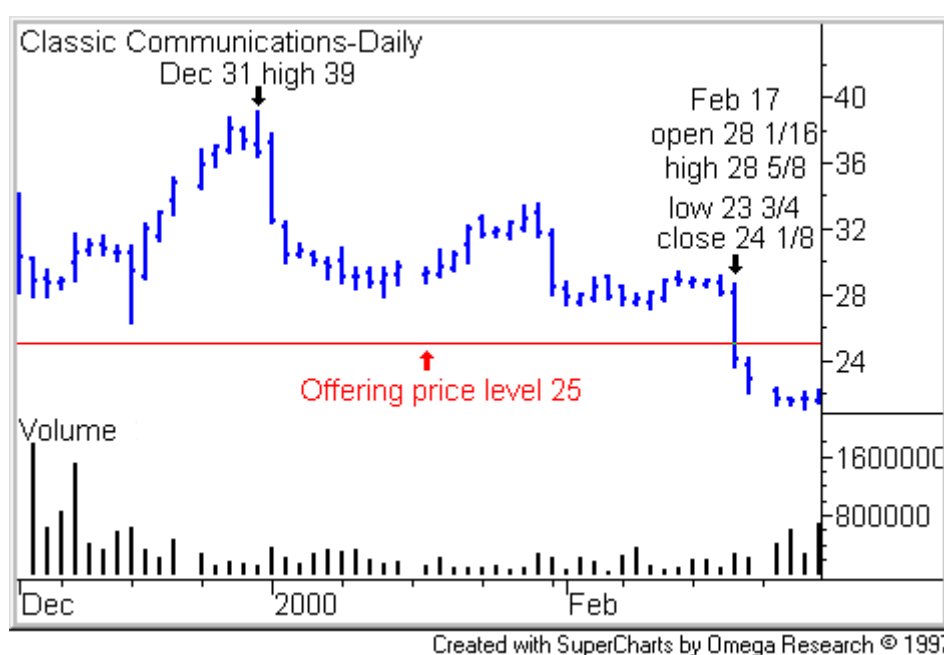
However, the 10-to-20 move represents a 100% gain. The 100-to-110 move represents a 10% gain. Obviously, these are very unequal moves! Which trade would you prefer to be in?

A log chart eliminates this distortion by depicting percentage price changes rather than absolute price changes. A move from 10 to 20 would look about ten times as big as a move from 100 to 110.

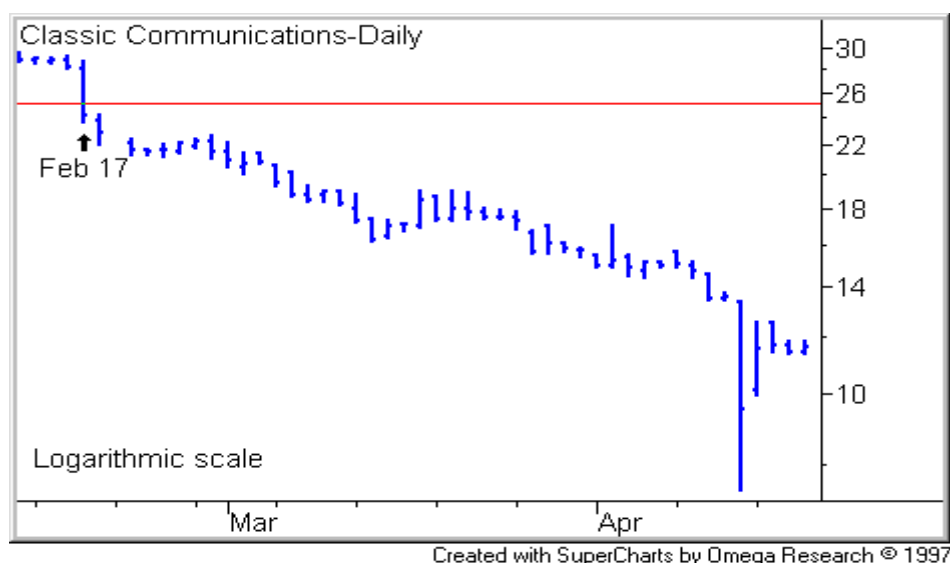
When I resort to a log scale, the chart itself will identify itself as a log-scaled chart somewhere in the lower left-hand portion of the graphic. Unless otherwise indicated, the chart will be plotted on a linear scale.

You also can tell if a chart is on a linear or logarithmic scale just by looking at the price scale on the right-hand margin. The price key of a linear chart will be measured in equal increments.

For instance, let's take a second at the first Classic Communications chart. Read along the right-hand margin from top to bottom. The price key reads 40, 36, 32, 28, 24 -- equal 4-point, or \$4, increments. Also notice that margin numbers are spaced the same distance apart. Those nice, regular increments mark this as a linear-scale chart.



Now look at the other Classic Communications chart, shown below. The price key reads 30, 26, 22, 18, 14, 10 from top to bottom. And the numbers are spaced between each other by different-sized spans. Obviously, a log scale.



Now let's move on to another great IPO short.

eToys

Not every new issue gives up the ghost as soon as it violates its offering price. Sometimes, a stock will pierce its offering price, then rally just enough to stop you out.

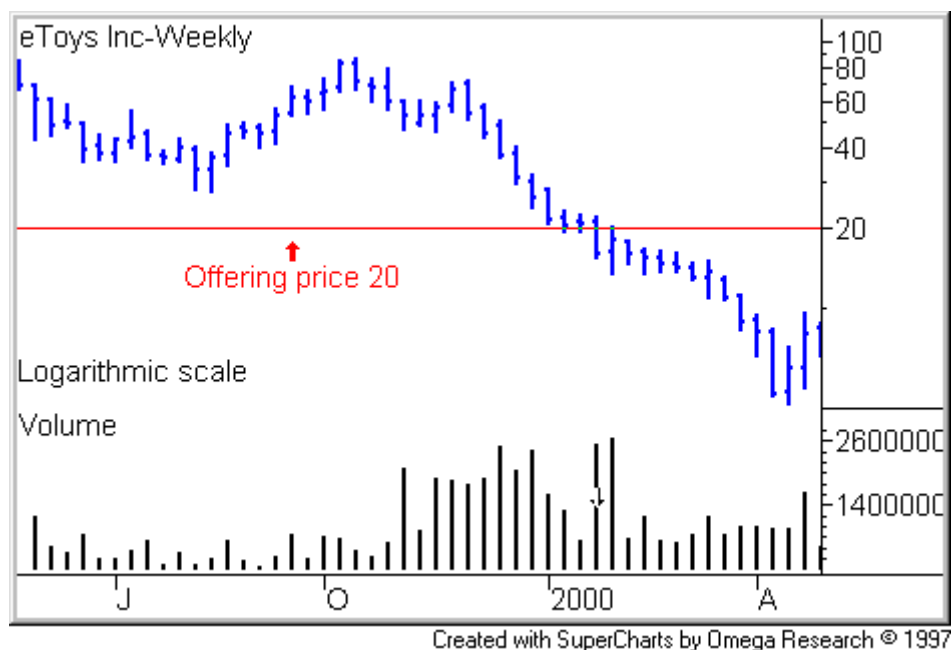
In such cases, don't relax your protective stop. Cover your short and protect your precious hide.

But don't give up. The stock may roll over and pierce its offer again. If so, short it again. A stock that repeatedly attacks its offering price is showing clear signs of rocking against the ropes. Keep hitting it.

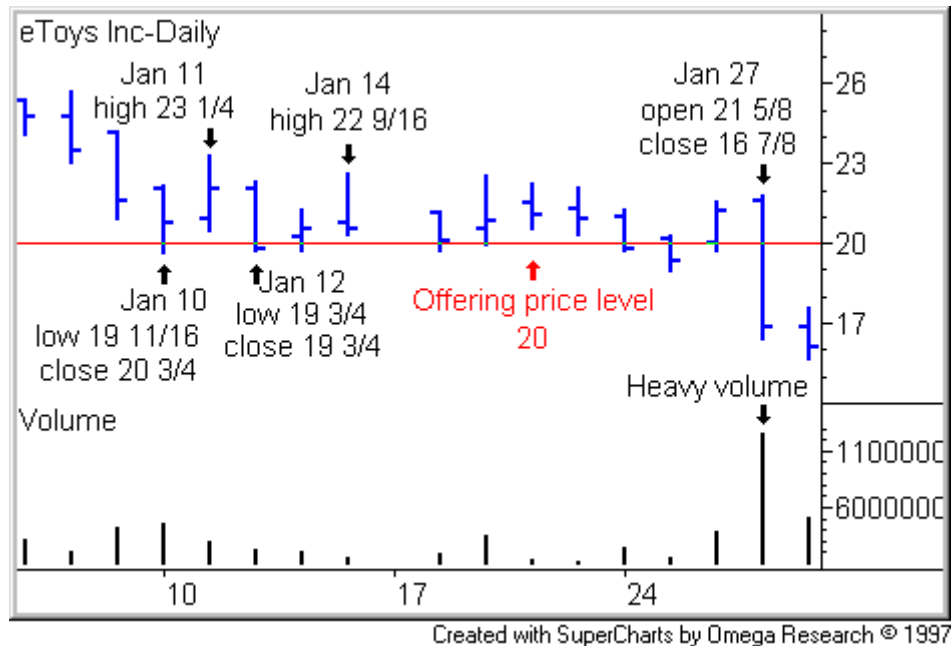
My next example shows the fruits of persistence.

eToys Inc., a Web-based retailer of toys, games and other children's products, came public on May 20, 1999. The company sold 8.3 million shares at an offering price of \$20 a share. Goldman, Sachs, the bluest of the investment bank bluebloods, served as lead underwriter.

As the following weekly chart shows, eToys enjoyed a long advance before topping at 86 in mid-October 1999 and entering the decline that would eventually violate the offer.



Now let's move in for a closer look on a daily chart.



eToys shares first breached the offering price on Jan. 10, 2000, nearly eight months after the company's IPO. The stock fell to a low of 19 11/16 -- triggering a short-sell signal -- before closing back above the offer at 20 3/4.

Let's say you shorted eToys at 20 a share, setting a 15% stop at 23. The stock would have stopped you out the very next session as eToys rebounded to a Jan. 11 intraday high of 23 1/4.

The bounce proved short-lived, though. The stock fell below the offer again. You would short again. This time, if you shorted at 20 using the same 15% stop, you would have held one, even though eToys tried to hold above the offer for a few more sessions.

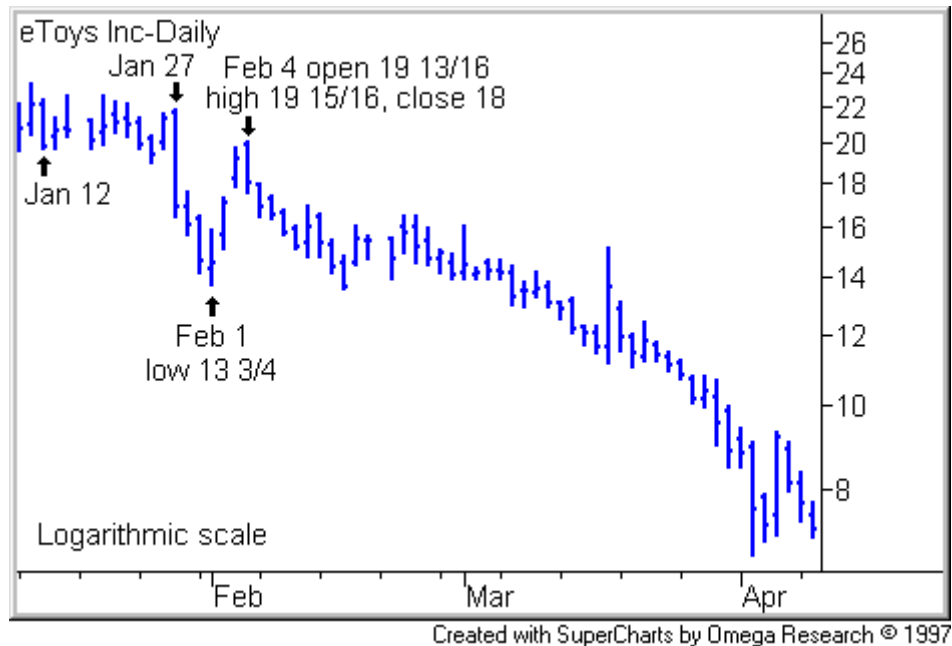
On Jan. 27, eToys succumbed, plunging to a close of 16 7/8. Adding to the authority of the move was a big surge in volume as shareholders fled the stock.

Take the Money and Run

Making money trading stocks requires *three* correct decisions. You must enter the trade at the right moment, stay in long enough to make a profit, and then exit in time to lock in your profit.

For short-sellers, that means short-selling right as the stock enters a decline, next giving the stock enough time to fall and rack up a nice profit, and finally buying back the shares in time to cover your short at a fat gain.

Another look at eToys trading action illustrates the point.



As you can see, eToys fell hard after breaching the offer on Jan. 27. Moving your stop down to 20, then trailing the rest of the way down would have kept you in the trade until the stock rallied on after tagging a Feb. 1 low of 13 3/4.

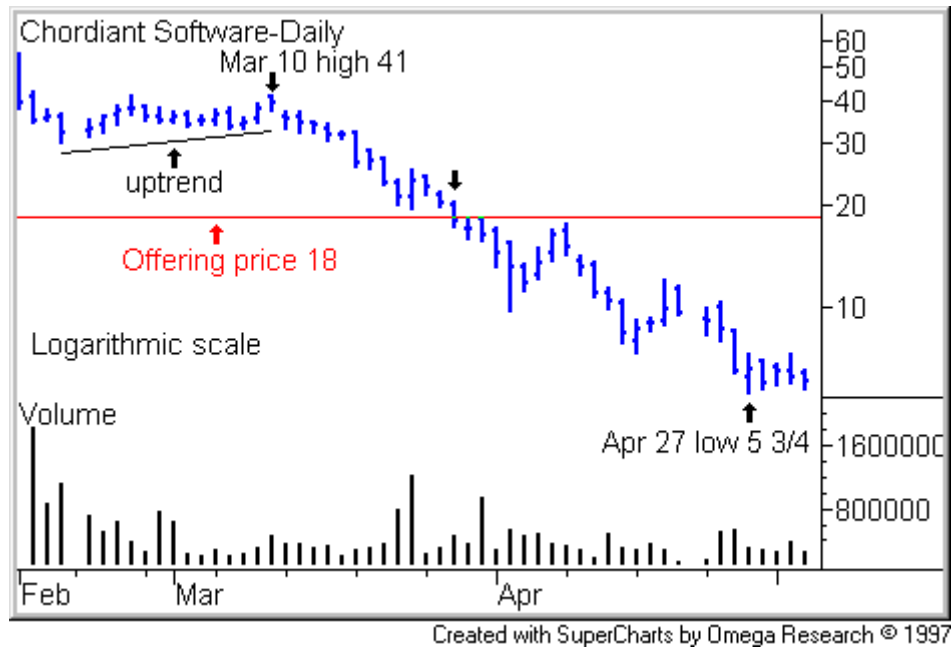
The eToys example shows another behavior that can crop up in new issues after they penetrate below their offering prices. Once violated, the offering price becomes a ceiling or resistance level.

If a new issue breaks below the offer, then rallies back and stalls below the offer, then heads south again, this can scare the willies out of the remaining, probably nerve-wracked bulls still in the stock. Their resolve cracks. Holders turn into sellers. *Et voilà!* You have a fresh opportunity to short the stock.

Let's look at another example.

Chordiant Software

Chordiant Software Inc. offered shares at \$18 per share on Feb. 15, 2000. FleetBoston Robertson Stephens acted as lead underwriter. The Cupertino, Calif.-based company develops and markets e-business software.



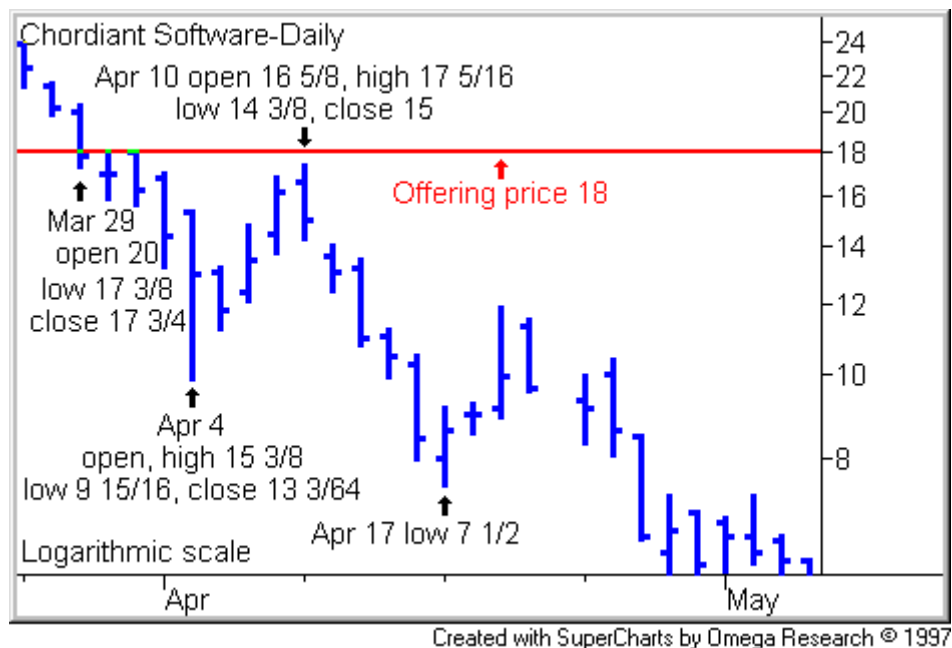
As you can see, Chordiant met all the requirements for a short at the offer. The stock established an uptrend, then entered a decline after topping on March 10.

Well before nearing its offering price, the stock began making new lows. A succession of new lows, of course, is very bearish for a stock. Everyone who went long the stock after the IPO has a loss. They're all in pain.

And with the stock making new lows, there's no historic support level. So where will these shareholders hope for the stock to make a stand?

Some will pray for stand at the offer, even though the syndicate has long since stopped supporting the stock. After all, didn't all those investment banking geniuses figure out that the offering price was a bargain for all those sophisticated big-money institutions? Chordiant has *gotta* rally at the offer, doesn't it?

Let's zoom in for a closer look.

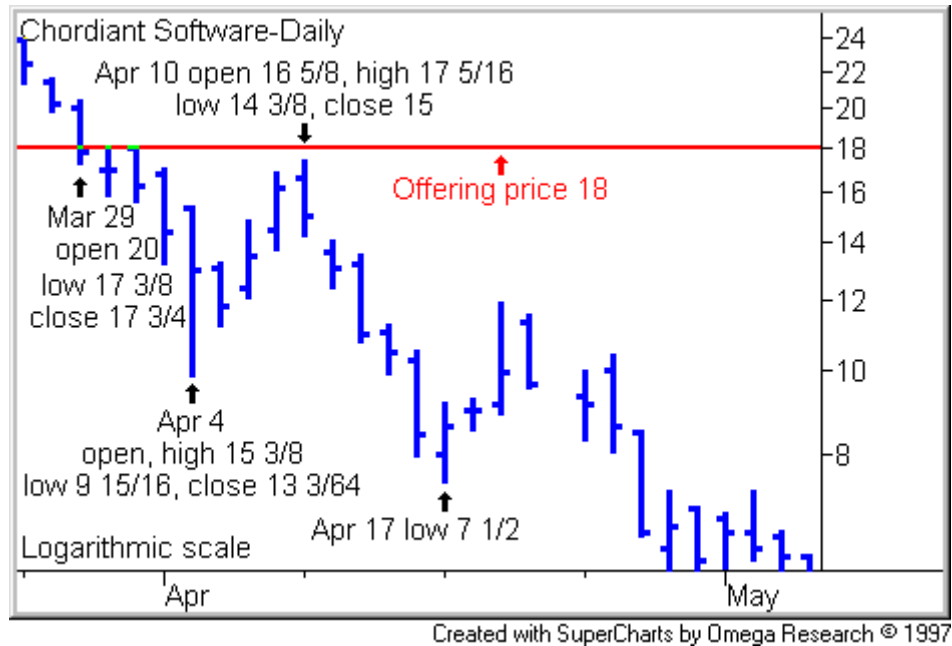


The answer to their prayers came on March 29. Chordiant opened at 20, then sliced through the 18 level, in which case you would short the stock. Shares closed at 17 3/4. The next two days, Chordiant rallied up to an intraday high of 20 but never crossed above. Instead of serving as a **support level**, the offer became a **resistance level**.

One Stock, Two Shorts

You'll see that Chordiant provided two short-selling opportunities, based on its trading action around the offer. You also would have taken profits in between.

Let's look at the chart again.



Shorting at 18 and setting your stop at 20 5/8, you would have enjoyed a fast, sharp ride over the next four trading days as the stock plunged to an April 4 intraday low of 9 15/16.

On the way down, you would have lowered your stop to 18 once the stock reached 13 1/2, a 25% profit. Further down, you would trailed your stop lower.

With every move lower, you would tighten your stop. As the stock rallied back on April 4, your trailing stop should have stopped you out.

From here, Chordiant rallied over the next several trading days. The rebound fizzled on April 10. The stock opened at 16 5/8, then peaked at 17 15/16 and turned tail.

A natural point to short would have been near the end of the day, provided the shock was near the low of the day's trading range and below the prior day's close. It didn't hurt that Chordiant also ended the day below the open.

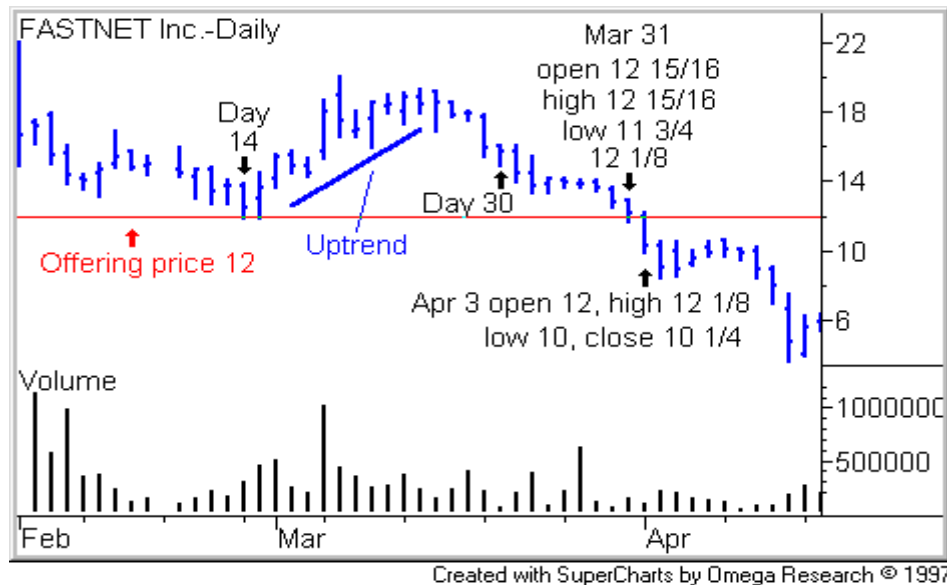
Assuming you shorted Chordiant at 15, you would have set your 15% stop at 17 1/4. From there, Chordiant rolled over hard, hitting an April 17 low of 7 1/2 before putting in another bounce on the way to lower lows.

Pattern Recognition

Learning to recognize setups and patterns boils down to practice. You look at chart after chart. In time, the trading opportunities stick out like sore thumbs.

So let's give your eyeballs a workout!

The accompanying chart shows FASTNET Corp., an Internet service provider. The company sold 4 million shares at an offering price of \$12 a share on Feb. 8, 2000. ING Barings acted as lead underwriter.



FASTNET shares opened well above their offering price, went into a decline and found support at the offer on the 14th day of trade.

Now so far, this is not the profile we're looking for. Mindful of staying out of the way of the syndicate, you won't short a new issue until 30 days or more from the IPO. We also want the stock to trade higher, then break down into a decline.

But after finding support at the offering price, FASTNET moved higher, establishing the looked-for uptrend. Then the stock took a bearish turn. By Day 30, the stock was entering a downtrend.

This time, when the stock hit its offering price, it failed to find support. A decidedly bearish turn. If you shorted at 12, you would have set your stop at 13 3/4. The stock balked feebly around the offer March 31-April 3, but never came close to the stop.

FASTNET shares slumped, tried to hold up in the 8-9 a share range, then cratered. The stock recorded an April 14 low of 3 3/4.



Retest and Flunk

How would you like to lead a run on a bank?

E-Loan Inc., an online provider of consumer credit and small business loans, came public at an offering price of \$14 a share on June 29, 1999. Goldman Sachs was lead underwriter. Here's a weekly log chart of the stock from IPO into May 2000.



As you can see, being vetted by one of Wall Street's prestigious underwriters is no guarantee of long-term success.



Notice that E-Loan found support at the offer on Jan. 21 and 24, 2000. The stock pulled higher for a few days, then reversed. Anyone expecting E-Loan to retest the support level and rally would have given E-Loan a failing grade.

A failed retest of any valid support level raises the odds that a stock is headed lower. When the support break coincides with a break below the offer, that increases my confidence that the stock is in for a serious markdown.

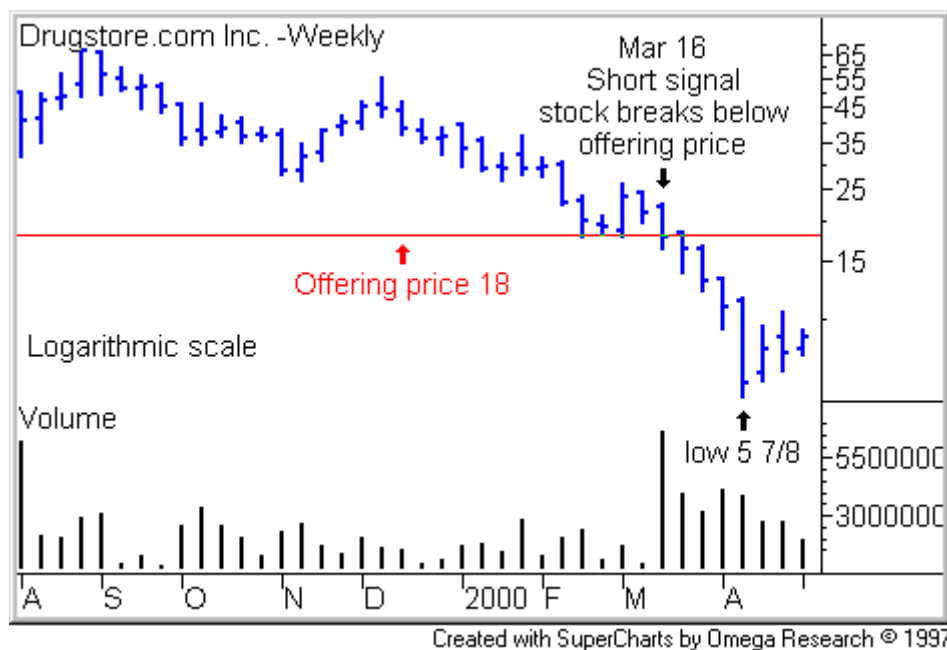
Overdose

Here's another great example of a stock that behaved like the offer was a price floor, then caved below it.

As you look at the following chart, think about the nature of the short-seller's prey. You're on the lookout for **bearish changes in the character a stock**, as expressed in its trading behavior. Advances give way to declines. Support levels break down. Broken support levels become resistance levels.

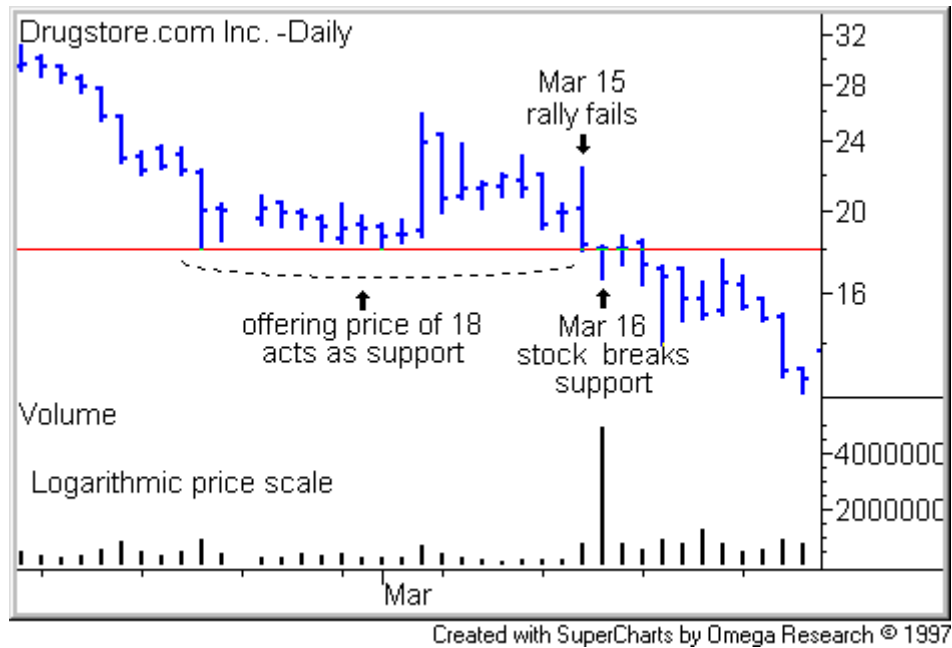
Drugstore.com is engaged in developing e-commerce opportunities in health, personal care and pharmacy products. The company came public on July 28, 1999, offering its common stock at \$18 a share. The underwriters were Morgan Stanley Dean Witter, Donaldson, Lufkin & Jenrette and Thomas Weisel Partners.

The following chart shows the stock from IPO, through the short signal, into May 2000.



As you can, Drugstore.com shares found support at the offer, never triggering a short signal by breaching the 18 level intraday. When the violation finally came, the stock went down for the count.

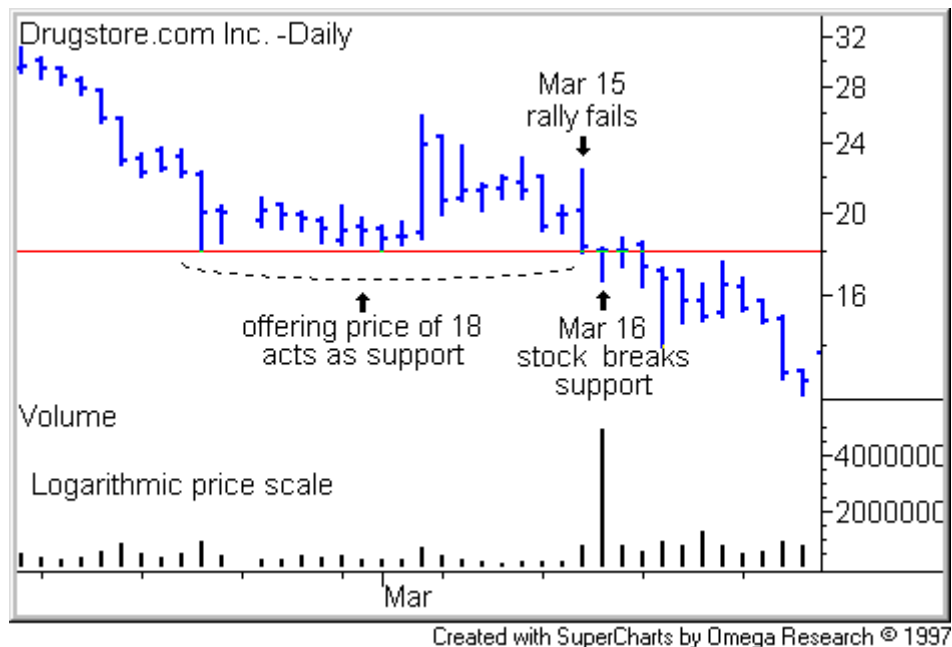
This shows up clearly on a daily chart.



Like the preceding example of E-Loan, Drugstore.com made a last-ditch effort at a rally to put some distance between the stock and the offer the day before the breach.

On March 15, E-Loan opened at $20 \frac{1}{16}$, pressed on to a session high of $22 \frac{3}{8}$, then turned tail. The stock bounced off the offer and closed near the bottom of the day's range at $18 \frac{1}{4}$. A bearish performance if there ever was one.

You can see this better upon closer inspection of the daily chart.



I hope this installment of **Trading Hot IPOs** has proved rewarding for you. Next week, we'll pull together all that we've learned.

WEEK FIVE *Applying The Plan To Your Trading*

Welcome to the final installment of my five-week course, **Trading Hot IPOs**.

Now I'm going to show you how to use a unique set of tools created by TradingMarkets to help you spot newly issued stocks that may be ripe for long trades or short sales. And I will also give you some final tips for trading new issues.

In prior installments, I've taught you the essential factors that cause new issues to behave differently as a class of stocks vs. the general market. Then I showed you three effective setups for trading new stocks:

1. **Hot IPO Pullback**, a setup for short-term buys;
2. **First-Stage Base**, a setup for intermediate-term buys;
3. **Shorting the Hype**, a setup for short-selling.

With the right data feeds, software and programming skills, you could take the setup parameters laid out in this course and write your own programs to track down stocks fitting the trading profiles.

But TradingMarkets has already done this work for you! Every night, we will post in the IPO area of the TradingMarkets Stocks section, lists of any stocks that we find meeting one of these three trading profiles.

You can find this section by clicking on the **Stocks tab** near the top of the TradingMarkets home page, then clicking on the **IPO tab**. There you will find three **Indicators**, each listing stocks potentially meeting one of the three trading setups described in my course.

Your Power Tools for Trading IPOs

You can find generic information on IPOs and new issues all over the Web. The TradingMarkets.com IPO section gives you something unique and much more powerful:

A nightly listing of new stocks that appear close to completing tradable setups and patterns.

First, we created a database of stocks that have traded less than one year. We'll keep this database up-to-date, dropping out stocks as they exceed one year of trading, adding new stocks as more companies come public.

Second, TradingMarkets has programmed its computers to sift this new issues database for stocks meeting the *Hot IPO Pullback*, *First-Stage Base* and *Shorting-the-Hype* setups.

After each market close, we'll run the scans and update the changes to the three **Indicators** devoted to the three trading setups.

The Rewards of Patience

On some days, candidate issues for long or short trades will be few and far between. On other days, TradingMarkets will detect numerous stocks meeting one or more of the three setups described in this course.

There are a couple reasons for this. New issues represent a fraction of the thousands of stocks traded in the U.S. Also, new issues are extremely susceptible to general market trends. In a bear market or severe correction, new

stocks suffer much worse than the general market. That means few long-trade setups. In a bull market or rally, new issues tend to outperform. Meaning relatively few short-selling opportunities.

But when these setups do occur, under the right conditions, new issues can produce powerful, tradable moves to the upside and downside. If you are patient and committed to checking the setup listings each night, I believe you will find the rewards well worth your time and effort!

The Indicators

The Indicators are pretty straightforward. For each setup, *Hot IPO Pullback*, *First-Stage Base* and *Shorting-the-Hype*, TradingMarkets has established a daily list of stocks that may close to completing the profile and triggering a buy or short signal.

The idea is the catch these bases *before* the signal flashes. That way, you have advance notice to load the tickers of the stocks that interest you into your own real-time alert software.

Depending upon market conditions, there will be many nights where no stocks qualify for this list.

Once you enter one of the Indicator's lists, the information displayed on the listed stocks, if there are any, should be pretty straightforward.

For each listed stock, you will see the ticker symbol, a chart link, the name of the stock, its industry or subsector, price and price change from the previous day's close and a variety of technical information.

For instance, you will see the stock's trading volume for the prior session and its average daily volume based on the 50 past sessions. Broadly speaking, price moves that occur on greater volume portend more about future price moves than do price moves on lesser price moves.

Because these are new issues, they won't have 12-month relative strength scores. Many will lack 6-month RS as well. TradingMarkets also provides a three-month RS. To the extent you have relative strength data on a stock, use it. As a general rule, when trading long, the higher the RS the better. And when shorting stocks that break below their offer, the lower the RS the better.

Just by moving your cursor over the label of each datum, the Web site will provide a pop definition of that particular item. For instance, place your cursor over **ADX**, one of the technical information items provided on listed stocks. Up pops the definition:

"The Average Directional Movement Index (ADX) is a technical indicator that measures trend strength but not direction. The higher the ADX reading, the stronger the trend -- up or down."

Now click on the little chart icon for one of the listed stocks on the Indicator. If you've never used this feature before, I think you'll be happily surprised.

When you click on the chart icon, up will come a chart of the selected stock. Now click on "Show Controls." Here you will find an amazing set of options, allowing you to change the type of chart to your heart's content.

For instance, you can plot over time frames from a single day to past a decade. You can set the frequency to minutes, days, weeks, quarters. There are eight different ways to display price movements, such as open-high-low-close, candlesticks and log scales. You can compare your stock against indexes and against other individual stocks.

You can include other indicators like moving average lines, volume, money flow, volatility, on so forth. This is an incredibly versatile tool that you can customize to your own trading requirements.

Trading Off the Indicators

The purpose of the **Indicators** is to alert you to brewing setups before they trigger buy or short-sell signals. After scrutinizing the candidates, let's say that you decide to buy an Indicator stock if it provides an entry signal. The next step is to identify your entry point, then continuously monitor the stock to catch the buy or short signal in the event of a signal.

The only way I know to do this is either to eyeball the stock in real-time yourself or load it into a scanning program that will alert you in real-time if the stock hits your buy or short-sell price. There are a number of providers of this service. For introduction to real-time quote providers, check out my introduction on real-time quote providers, [I Need Those Quotes Yesterday!](#).

Other Bells & Whistles

In addition to watching the trading action of new issues, I find it informative to keep tabs on IPOs that are in the pipeline. TradingMarkets makes this convenient with our IPOInfo section, located just below the Indicators.

In particular, I like to keep an eye on new issues being prepared for market, which you can find in the **Calendar**, and issues being withdrawn, found in the **Withdrawn** list. A pickup in either could signal a bullish or bearish shift in the way the market perceives new issues already trading as well as its receptiveness for more offerings.

Stay Agile

I learned long ago that successful pattern trading requires more than just plugging in an alert price, entering a trade if your signal is hit, then giving up on the stock if it hits your initial protective stop.

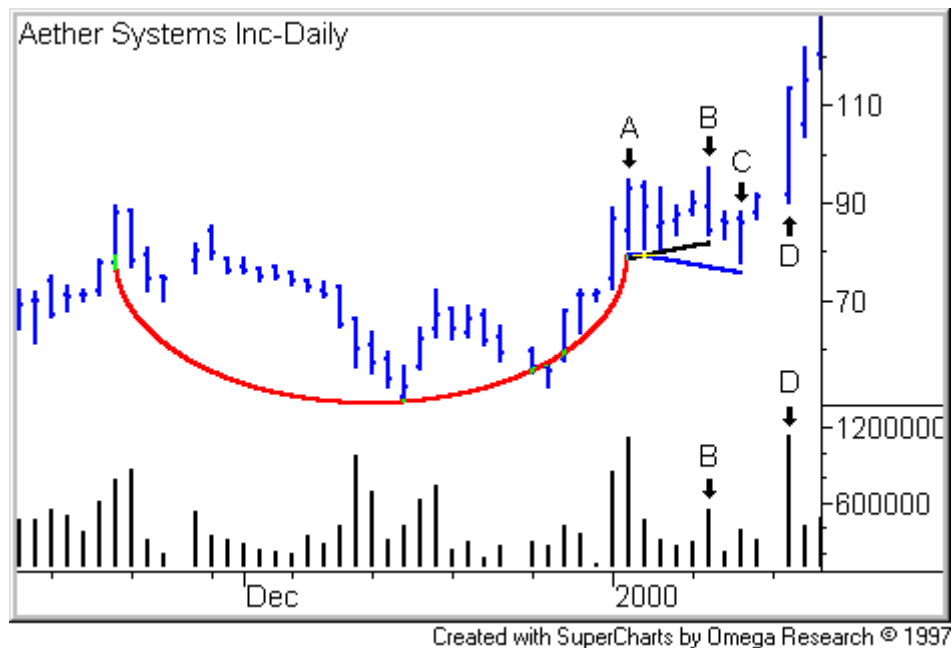
New issues are especially volatile. Sometimes, you'll get stopped out of a stock, only to see it reset and take off for a great run. This is especially the case with new issues coming out of first-stage bases.

In such cases, don't give up. You might have entered the trade prematurely -- before the base really completed itself prior to the breakout. If you suspect this might be the case, continue to monitor the stock. In a day or two, it might reset the base and break out. Hopefully, you'll be ready and waiting!

Let me show you an example of a new issue that could have thrown a trader a curve ball before breaking out of a fine cup-with-handle base. I describe this bullish pattern in detail in Week No. 3 of this course, which deals with first-stage bases, which can include cup-with-handles as well as other patterns.

Trading the Pattern

Aether Systems Inc. came public on Oct. 21, 1999 opening at 50 on its first day of trading. It consolidated three more days before heading higher and making a Nov. 19 intraday high of 89 3/8. The stock then entered a correction, recovered and in January 2000 appeared to be forming a cup-with-handle base.



As you can see, the stock formed a nice U- or cup-shaped correction-recovery pattern. This cup part of the pattern completed with the stock's intraday high of 94 1/2 on Jan. 4, 2000. See **Point A** on the chart. Then the stock began to drift sideways on low volume, an apparent handle.

On Jan. 11, Aether Systems shares attempted a break out. **Point B**. A breakout occurs when the share price climbs above the high of the handle. *If it's a proper handle*, you buy when the share price hits 1/8 point of the high of the handle.

The stock shot past the Jan. 4 high of 94 1/2. The breakout also should be accompanied by a strong pickup in volume, another key to confirming a cup-with-handle breakout.

Let's say you bought at 94 5/8 and used an 8% initial stop, setting your stop-loss price at 87. Your shares rose to an intraday high of 97. Then the stock reversed and fell to a session low of 83 7/8 before closing 84 7/8. Along the way, of course, you got stopped out.

But wait! If you bought on Jan. 11, you would have made a mistake. By that point, the handle was wedging upward, as defined by the lows of the handle. See the handle line **in black** on the chart.

Upward-wedging handles are prone to failure. A proper handle drifts downward. I've found that many traders miss this point and suffer otherwise avoidable losses trading off of questionable breakouts from upward-wedging handles.

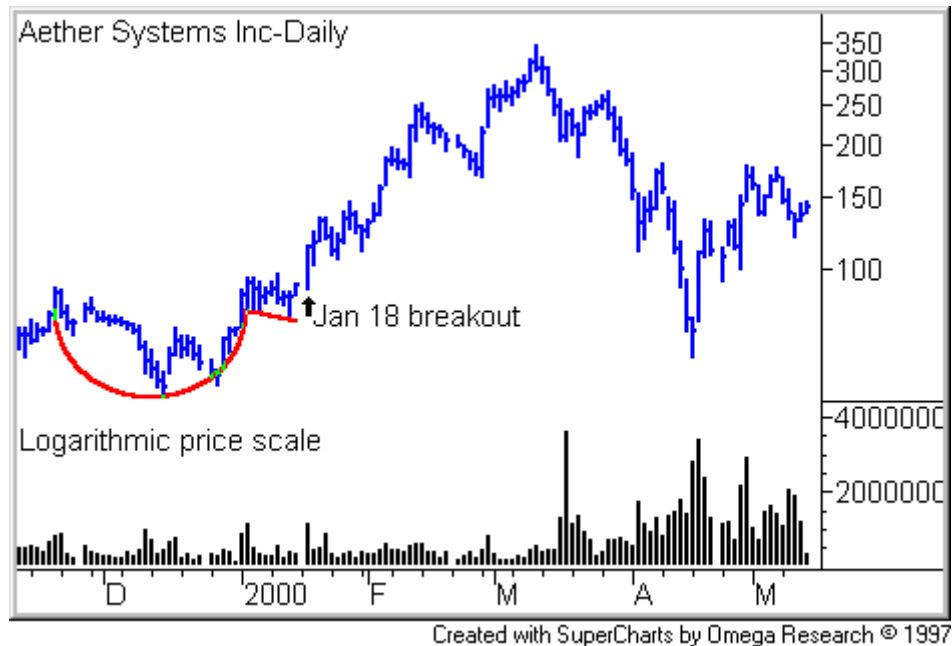
Now, you're sitting back in cash, having sold your Aether shares as soon as the stock tripped your loss.

A couple days later, the stock dropped to an intraday low of 78 before closing in the upper half of the day's trading range at 86. See **Point C**. Notice that price action **lowered the angle of the handle**. See the handle line **in blue**. Now you have a sound downward-pointing handle!

The next trading session, the handle tightened up while volume dried up, two more constructive signs. You now have a sound, tightening, downward-pointing handle. The first-stage base is intact and becoming more bullish.

Far from swearing off the stock because of your small loss, you should be standing ready to jump back in. This time, however, you have a new pivot point, the intraday high of 97 set on Jan. 11.

On Jan. 18, Aether took off, shooting past the high of the handle on a powerful flood of buying volume. From there, if you bought at 97 1/8 or within 5% of that level, you would have been off to the races.



Long Trades and the Market

As I've said several times throughout this course, new issues tend to react much more strongly to general market conditions than do other stocks. They outperform in rallies and bulls. They do even worse than most other stocks in bears and corrections.

You must respect this principle in long trades, where you buy in hope of profiting from future share-price appreciation. The market should be advancing or reversing upward from a recent decline.

Don't buy new issues in the face of a correction or bear market. You stack the odds enormously against yourself!

Short-term traders using the Hot IPO Pullback, which was invented by Jeff Cooper, can use his gauge of market uptrends. The general indexes should be above their rising 10- and 15-day moving averages.

Intermediate-term traders using the first-stage base also should buy in a rising market, preferably one confirmed by a follow-through day. For more on follow-through signals and other market gauging techniques of intermediate-term traders, read the [Kuhn/Marder Intermediate-Term Momentum Trading Course](#).

Short Trades and the Market

Ideally, I like to short individual stocks when the general market is in decline. However, this is not necessary when shorting new issues as they break below their offer.

When a newly issued stock violates its offer during a healthy, advancing market, in all likelihood something is seriously wrong with the company. In many cases, these stocks were rushed to market by their inside shareholders and underwriters simply to take advantage of a healthy market to cash in, regardless of the merits of the company.

Often, these companies are poorly **seasoned**, meaning they have few or no fiscal quarters under the belt with real sales and other bullish fundamentals. Such companies may depend on a single product line or have other traits making them exceedingly vulnerable to competition or other forms of adversity.

A Final Word

This concludes my five-week course, **Trading Hot IPOs**. Once you have thoroughly mastered this material, I believe you will find new-issue setups to be one of the most lucrative parts of your trading arsenal.

As a subscriber to TradingMarkets.com, remember that you're never alone. The other contributors to TradingMarkets and I are eager to help you achieve the best possible results in your trading. And that includes answer your personal questions.

So if you have any questions about the course or trading IPOs, I encourage you to contact me personally through the TradingMarkets Question & Answer section. You can e-mail your queries to questions@tradingmarkets.com. For the latest answers to subscriber questions, check out the Q&A section, linked at the bottom-right section of the TradingMarkets.com home page.

In the meantime, I hope you have found my course interesting and rewarding. I wish you the best of success in trading new issues!